# ISLAMIC BANKING

*An Alternative System*

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## FOREWORD

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**ABSTRACT**

Islamic banking is an investment and financing concept which expands globally. People are becoming more aware of the Islamic banks. Islamic banking is different from conventional banking in most aspects, since its close tie to religion is very important. The connections to politics and history have influenced the implementation of the Islamic banking system in the countries where the system operates.

The dissertation is based on extensive literature review and a personal interview with a professional within an Islamic bank in Lebanon.

Instead of being based on interest, Islamic banks offer various kinds of accounts and a range of financing alternatives all complying with the Islamic Law – Shari'a. To work according to Shari'a is crucial for the banks and their activities are controlled by a special Religious Supervisory Board. The implementation of the Islamic banking system varies to some extent between Islamic countries.

As a result to the variations between the states' implementation, the need for harmonisation increases as the expansion of Islamic banks continues. Several organisations work to achieve international standardisation and harmony to make the banking activities more transparent and attractive. The achievement of harmonisation as well as the performance of the banks is crucial for the future of Islamic banking.

**Keywords:** Islamic banking, Shari'a, Finance, Regulatory organizations, International implementation

**LIST OF FIGURES:**



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Chapter One

# 1. INTRODUCTION

*This chapter will present the purpose, research questions, limitations, definitions and methods used as well as the authors, upon whose works, we have based this dissertation.*

Islamic Banking is a rather unknown concept in the Western World and at best only associated with a dislike to interest. The idea of Islamic Banking, however, contains much more than its prohibition of interest. Islamic Banking shows that ethic and finance can be connected to serve the society. The idea behind the banking system is to eradicate injustice in society.

The obvious connection to the religion Islam might cause suspicion among Western citizens perhaps more out of fear for the unknown. In the global society of today the Arab World and its Islamic banking system gets closer to us and needs to be dealt with.

When Islamic banking with its ethical values first appeared, it was treated as a utopian dream by the financial circles in the world. The attitudes, however, are changing gradually and in the last few years the value neutral conventional banking has begun to trouble the conscience of an increasing number of people. There is a reluctance to hand over the funds to banks and financial institutions that invest in companies engaged in unethical and socially harmful activities.

This dissertation aims at clarifying the issue of Islamic Banking and explains some of its connections to politics, history and religion.

## 1.1. PURPOSE

The purpose of this dissertation is to describe the Islamic banking system and how it is implemented in some selected countries.

## 1.2. RESEARCH QUESTIONS

The dissertation is based on following research questions:

- What is Islamic Banking?
- How does the system work and what are its components?
- How is Islamic Banking implemented in different countries?

## 1.3. LIMITATIONS

Limited time as well as limited scope has caused us to restraint the dissertation to Islamic Banking/Finance. We have therefore excluded the closely connected subject Islamic Insurance.

## 1.4. DEFINITIONS

| | |
|---|---|
| AAOIFI | Accounting and Auditing Organization of Islamic Financial Institutions. See p 74 |
| Bai Al-Salam | Advance Payment or Forward Buying. See p 38 |
| Bai Istisna | Commissioned Manufacture. See p 39 |
| Bai Muajjal | Credit Sale, Sale on deferred-payment basis. See p 38 |
| Hadith | Sayings, deeds and reactions of Prophet Muhammad narrated by his Companions (Iqbal & Llewellyn, 2002). |
| IFI | Islamic Financial Institution. See p 20 |
| IFSB | Islamic Financial Services Board. See p 73 |
| Ijara | Leasing. See p 40 |
| Ijara wa-Iqtina | Leasing and purchase. See p 40 |
| Islamic banking | A system of finance based on the sharing of risk and profit, rather than on the payment of interest (Economist, 1992). Banking in consonance with the ethos and value system of Islam (Al-Omar & Abdel-Haq, 1996). |
| Islamic windows | Islamic services provided by conventional banks. |
| Islamisation | A process of changes to conform to Islam. |
| MENA | Middle East and North African countries. |
| Mudaraba | Capital Trust Financing, Commenda Partnership, Finance Trusteeship. See p 33 |
| Mudaraba accounts | General Investment Accounts, Profit-and-Loss-Deposits. See p31 |
| Murabaha | Cost-Plus profit contract or Mark-up contract. See p 36 |
| Musawama | A form of Sale contract. See p 56 |
| Musharaka | Equity Partnership Financing. See p 35 |
| Petro-dollars | A dollar earned from the exporting of petroleum. |
| Profit-loss sharing | System where profit and loss are shared between contracting parties. |
| Riba | Interest, Usury. See p 27 |
| Shari'a | Refers to the corpus of Islamic law based on divine guidance as given by the Koran and the Sunnah and embodies all aspects of the Islamic faith, including beliefs and practices (Iqbal *et. al*., 2002). See p 15 |
| Sunnah | The Sunnah is the most important source of the Islamic faith after the Koran and refers to the Prophet's example as indicated by his practice of the faith (Iqbal *et. al.,* 2002). |
| Zakat | The amount payable by a Muslim on his net worth as a part of his religious obligations, mainly for the benefit of the poor and the needy (Iqbal *et. al.,* 2002). See p 13 |

## 1.5. METHOD

This dissertation is to the larger part based on secondary data. We have also used primary data. The primary data has been collected through a personal interview with Mr. Nader Khatib, Chief Teller at the Arab Finance House SAL, an Islamic bank operating in Lebanon. The interview took place at the head office on Charles Malek Avenue, Achrafieh, Beirut, on November 11th, 2004.

Secondary data has been collected from several sources. Relevant literature has been gathered from a number of libraries. Extensive data has only been collected through numerous different databases, websites and articles. To receive objective information works by different authors and organizations have been used. Since we have mainly used secondary data, most of which is written in English, in our dissertation we have chosen to shortly present those authors most used in our work.

## 1.6. PRESENTATION OF AUTHORS

The literature has been chosen on the basis of several facts. The authors are present in a wide range of geographical areas. They all have large experience in relevant subjects and have important positions in different workplaces and organizations.

**Al-Omar, Fuad & Abdel-Haq, Mohammed**. Islamic Banking: Theory, Practice & Challenges

Dr Fuad Al-Omar is Vice-President (Finance) of the Islamic Development Bank (Jeddah), Vice-Chairman of the Organization of Accounting Standards for Islamic Financial Institutions (Bahrain) and for the past several years has also been Chairman of the Islamic Banks Meeting, which is the largest international forum of Islamic banking institutions.

Dr Mohammed Abdel-Haq is currently a Manger at a London-based merchant bank. Since receiving his doctorate from Oxford Brookes University, he has written extensively, as well as leading seminars and conferences, on various aspects of the subject of Islamic banking.

**Archer, Simon & Abdel Karim, Rifaat Ahmed (eds)**. Islamic Finance: Innovation and Growth

Simon Archer is Professor of Financial Management at the University of Surrey, England. Previously, he was Midland Bank Professor of Financial Sector Accounting at the University of Wales, Bangor.

Rifaat Ahmed Abdel Karim is the Secretary-General of the Accounting and Auditing Organization for Islamic Finanical Institutions (AAOIFI), a post he held since 1995. He is a member of both the Standards Advisory Council and the Financial Activities Advisory Committee of the International Accounting Standards Board (IASB), and Chairman of the Review Committee formed by the IASB to prepare the approved Arabic translation of International Accounting Standards.

**Henry, M. Clement & Wilson, Rodney (eds)**. The politics of Islamic Finance

Clement M. Henry is Professor of Government at the University of Texas at Austin.

Rodney Wilson is Professor of Economics in the Institute for Middle Eastern and Islamic Studies at the University of Durham.

**Warde, Ibrahim**. Islamic Finance in the Global Economy

Ibrahim Warde is a Lecturer at the University of California, Berkeley and an international consultant specialising in global economics and finance.

**Zineldin, Mosad**. The economics of Money and Banking

Dr Mosad Zineldin was in 1990 doing research at the department of Business Administration, University of Stockholm. He has extensive administrative, lecturing and practical experience in the field of economic, banking and finance.

## 1.7 OUTLINE

The rest of this dissertation will be presented in the following way.

Chapter two describes the environmental background of Islam, ownership, wealth, almsgiving and the Islamic Law- Shari'a.

Chapter three moves on to discuss Islamic Finance, its environmental background, emergence and spread as well as contracts and business relations.
Chapter four shortly presents Islamic financial institutions.

Chapter five describes the environmental background and different categories of Islamic banks and also presents the concept of Islamic banking followed by the aims and activities of Islamic banks in general. It moves on to discuss interest-*riba,* why it is prohibited and the different interpretations of the meaning of *riba.* Furthermore the different accounts are presented and the chapter is ended by a description of the financing alternatives offered by the Islamic bank.

Chapter six gives an overview of the presence of Islamic banks in Muslim countries followed by descriptions of the situation in selected countries.

In chapter seven the Shari'a Supervisory Boards are presented as well as different organizations working to achieve international harmonization within the Islamic banking system.

In chapter eight the Islamic Development Bank is briefly presented.

Chapter nine shortly presents Islamic banking in non-Muslim countries.

Chapter ten discusses specific problems that Islamic banks might encounter and the future of Islamic banking.

This dissertation is ended with the reflections written in chapter eleven.

**Chapter Two**

# 2. BACKGROUND

*The environmental background of Islam, the Islamic view on ownership, wealth and almsgiving and the Islamic Law – Shari'a will be described.*

## 2.1. ENVIRONMENTAL BACKGROUND OF ISLAM

In order to understand Islamic finance, it is necessary to have certain knowledge about the history and the tenets of Islam. It is also important to be familiar with Islam's position within the society, which is different from the religious power within the Western countries. It is not always easy for individuals used to the Western traditions to understand the teachings of Islam. (Samuelsson, 2000)

*Islam* means 'submission' which points out that a believing Muslim should submit to the will of Allah. It might be worth mentioning that the expression 'the will of Allah' has a quite different meaning to the true Muslim than to the secularised Western citizen. The superiority of Allah in the eyes of the Muslims forms the foundation for both Islam and Islamic banking. The Koran is the holy book of Islam and to be seen as the true words of Allah. (Samuelsson, 2000)

There are five pillars or corner stones in Islamic faith; the Islamic Confession, the daily prayers, the fast during Ramadan, the almsgiving and the pilgrimage to Mecca. (Samuelsson, 2000) Since the main topic of this dissertation concerns the financial part of Islam, the corner stone about almsgiving naturally receives most interest. Before studying the almsgiving more closely, one should take a look at what Islam teaches about property and wealth in general.

### 2.1.1. Ownership and wealth

In Islam brotherhood and justice are strongly pointed out and the well being of society is more important than the well being of the individual. Efforts made to improve or expand production in order to raise the output are good and worth struggling for, but justice and fair play at all levels of human interaction must take place. Wealth or income is considered as a favour from Allah and not as an evil. Heaven is open equally to the rich and the poor.

Poverty is not necessarily associated with virtue. It is, however, still considered as provocative if wealthy people boast with their wealth. If a rich person sees his- or herself as being superior to other people, it is a blasphemy against Allah. (Samuelsson, 2000) What matters is not whether a person has wealth but how it is obtained and how it is used. Wealthy persons should use their wealth in the community to gain society. (Al-Omar *et. al.*, 1996)

To better understand the behaviour of consumer and producer it is useful to study the concept of property within Islam. The following three points are particularly relevant. (Al-Omar *et. al.*, 1996)

1. Property is unconditionally owned only by Allah
2. Property among human beings is a form of stewardship or care taking – in other words: it is conditional. A person is answerable to Allah for the use of every property he or she uses.
3. Conditional ownership is either collective or individual:
    - Collective ownership: fundamental natural resources as water, air and fire
    - Individual ownership: things as goods, buildings, livestock and rights to lease, rent or re-sale

According to Islam, "Allah owns all resources and man is only a trustee in their use" (Al-Omar *et. al.*, 1996, p 5). Therefore, the economic aspect of how to handle those resources in real life is also not completely free. There are moral and legal constraints.

### 2.1.2. Almsgiving - *Zakat*

As mentioned above, one of the five pillars or duties in Islamic faith is the almsgiving, the z*akat*, which literally means 'purification'. Persons with resources above an exemption limit are to pay an amount levied on their wealth in order to purify the wealth and the person's soul. (Al-Omar *et. al.*, 1996) The main purpose of the zakat is redistribution of wealth and income. It has been regarded throughout Islamic history as the principal welfare system – a way of taking care of the poor and the needy in society.

It can be seen as a form of religious tax, even though the almsgiving in theory is considered to be voluntary. The true Muslim is also strongly encouraged to practise charity besides the zakat. (Warde, 2000)

In the Koran it is clearly written who should pay zakat, how much to pay and who the receivers are. Islam requires every Muslim, having resources in excess of a certain basic amount, to pay the zakat as a given proportion of her or his net worth or agricultural output. The zakat receivers are the poor and needy people or people in different kinds of trouble – independent of their religion. The zakat is paid once a year and calculated at 2.5 per cent of the total value of capital and profits minus unrecovered debts and depreciation. In agriculture it varies from 5 per cent to 10 per cent, according to the type of irrigation. (Al-Omar *et. al.*, 1996; Samuelsson, 2000; Warde, 2000)

The socio-economic function of the zakat aims not only at satisfying the hunger of a poor man or to help him with a few pounds. The purpose is also to enable him to support himself by his own efforts so that he may have a fixed source of income. This rescues the individual from the indignity of dependence on others or on the state, for a livelihood. This way of acting runs well with the special rules for collection and distribution of the zakat. The rules say that the zakat should be collected and distributed locally. It should also be made collectively and not by each individual. The reason for this is to avoid almsgivers from boasting with their actions and to prevent the zakat receivers from feeling ashamed. Many Islamic banks are involved in zakat – either through setting aside a percentage of their profits for charitable activities or through administration of zakat funds, collection or distribution of money. In countries where the ruler takes charge of collecting alms a zakat fund must be established in each Islamic bank. The Islamic bank can then play a technical assistance role in the government's fight against poverty. (Al-Omar *et. al.*, 1996; Warde, 2000)

In the early days of Islam, detailed rules as to amounts, collection practices, exemptions and the like were established for the practice of the zakat. This system, however, has changed through the years to fit the Islamic community's revenue and welfare needs of today.

The zakat payment has been replaced by modern tax systems in Muslim countries, but is, nevertheless, still considered as a religious duty among true Muslims. (Samuelsson, 2000)

There is a debate between the proponents of social solidarity, compassion and mutual obligation and the proponents of the sanctity of private property. The first part believes that the rich should pay to the needy, even beyond their obligation to pay zakat. The latter part, however, is of the idea that the only obligatory claim on the wealth of Muslims is zakat. This debate has apparently been going on since the death of the Prophet Muhammed. It is obviously related to the modern debate over the capitalist or socialist nature of the Islamic economic system. Since the Islamic economic system is based on the Islamic Law – the *Shari'a* – the main question is whether the practical economic purposes should be emphasised on the strict letter of the law or on the spirit of the law. (Nomani & Rahnema, 1994)

## 2.2. ISLAMIC LAW – *SHARI'A*

As the Islamic 'nation' grew, a need for a more detailed legal system arose. The Islamic Law is called the Shari'a and is defined as the Divine Law – the Law of Allah. It is mainly based on the Koran, the Sunnah and the Hadith. Among those sources the Koran has a superior place. The Koran is considered to be divine and eternal since it is the true words of Allah. (Al-Omar *et. al.*, 1996) The Sunnah contains the words and acts of the Prophet Muhammad and relates to the practice or ruling deduced from them. The Sunnah transmits and explains the Koran. The Hadith refer to a tradition or story of the Prophet. In short, the Sunnah is what was practised and the Hadith are the record of what was practised. Both the Sunnah and the Hadith refer back to the Koran. (Nomani *et. al.*, 1994)

The Hadith are – as Warde puts it – a collection of stories about and sayings of the Prophet Mohammad set down in writing two or three centuries later. It has become a source of controversy between Islamic groups since there are a number of interpretations of it. (Warde, 2000)

Since the Shari'a is the Law given from Allah, it is divine and not to be questioned by human beings. According to Al-Omar, human reason has considerable sovereignty *within* the law, but it has no sovereignty *over* the law. What Allah has prohibited cannot be made unconditionally permissible. The Divine Legislator is not bound by the limits of theoretical reason. What the law declares must be accepted and never doubted, even when it passes or appears to contradict human reasoning. (Al-Omar *et. al.*, 1996)

The statement of the Shari'a as a divine law is, however, denied by Amereller. He claims that the Shari'a should not be considered as a divine law like for instance the Ten Commandments, but instead be declared as a "body of Islamic law created and developed by jurists" (Amereller, 1995, p 25). According to Amereller, the Koran does not serve as a code of laws. The Koran and the Sunnah do mostly not contain clear laws and regulations, but decisions and hints that laws and regulations can be founded on. Therefore, law advisors are recommended only to use the Koran and the Sunnah if necessary. Much more are the interpretations of the Koran and the analogical conclusions of known jurists to be used. Those works were completed in the 10$^{th}$ century and considered as valid for coming generations. (Amereller, 1995)

The Shari'a does not allow certain condition as interest (*riba*) and gambling or speculation (*maysir*). From a Shari'a point of view, business and investments made by Muslims must be conducted in a responsible and committed way. (Archer & Abdel Karim, 2002)

The Shari'a might give the impression of being very restraining since it contains a number of prohibitions. On the other hand, the law includes the general principle that if nothing is specifically prohibited, it is permitted. (Al-Omar *et. al.*, 1996)

**Chapter Three**

# 3. ISLAMIC FINANCE

*The chapter includes a discussion about Islamic Finance, its environmental background, emergence and spread as well as contracts used and business relations.*

## 3.1. ENVIRONMENTAL BACKGROUND

Warde summarises the situation in the Islamic world in a comparison with the situation in Europe. "At a time when Europe was still in the Dark Ages", he claims, "culture and knowledge thrived in the Islamic world. Later, as the West went through its 'great transformation', the Islamic world remained stagnant". (Warde, 2000, p 25)

The so-called Golden Age of the Islamic world took place in the 7$^{th}$-10$^{th}$ centuries in the Middle East countries and between the 11$^{th}$-14$^{th}$ centuries in North Africa. The available financial instruments in the Islamic world were, Warde claims, at least until the 13$^{th}$ century far more advanced than in the West. Although banks did not exist, innovative financial instruments were a part of commercial life. A frequently used expression is that they were 'bankers without banks'.

After the Golden Age a period – between the 15$^{th}$ and the 20$^{th}$ centuries – followed, which is on the contrary remembered as a period of stagnation and decline. The reasons for this might be that the Islamic world suffered a double break – not only with its own past but also with the West. "The Renaissance, the Reformation, even the scientific revolution and the Enlightenment passed unnoticed in the Muslim world." (Warde, 2000, p 26)

The colonisation during the 16$^{th}$ and 17$^{th}$ centuries delayed the development of the Islamic financial models. Instead European banks were established at the end of the 17$^{th}$ century in Turkey, Egypt and Iran (Samuelsson, 2000; Zineldin, 1990). By the 19$^{th}$ century, most of the Islamic world was brought into a Western-imposed economic order for which it was ill prepared.

Between the Golden Age of Islam and this encounter, the world of ideas and institutions had changed dramatically. Most institutions with relevance to finance that exist today – capital markets, corporations, etc – did not exist in the early days of Islam. (Warde, 2000)

In some areas the classical Islam anticipates modern finance:

- Private property
- Emphasis on written contracts
- Favourable view of business endeavours

Some Islamic business forms, such as the commenda partnership (see further 5.5.2), have found their way in European legal codes.

Along with economic and political transformations came new perspectives on debt and indebtedness. Debt was no longer seen as something negative. With the rise of capitalism and the industrial revolution, it became logical that a nation needed not only skills and knowledge but also capital in order to succeed. In those countries where there was only little money to lend, the entrepreneurship was held back, which had a negative impact on the country. (Warde, 2000)

## 3.2. THE EMERGENCE AND SPREAD OF ISLAMIC FINANCE

Today, Islamic banking is estimated to be managing funds of US$ 200 billion. Its clientele is not confined to Muslim countries but are also spread over Northern Africa, the Far East, Europe and the United States. Islamic banking continues to grow. Islamic bankers, keeping pace with sophisticated techniques and latest developments have evolved investment instruments that are both profitable and ethically motivated. Today, more than 250 Islamic financial institutions are operating worldwide. (www.islamic-banking.com)

## 3.3. CONTRACTS AND BUSINESS RELATIONS

As mentioned before, Islamic finance is strongly based on the principles and rules of the Islamic Law – the Shari'a. The Shari'a contains rules about contracts, which are the main instrument in Islamic finance.

A branch of the Shari'a points out which contracts are permissible or valid, which ones to be used and which are not to be. It also gives instructions on how to form those contracts to avoid any form of confusion or disputes. The clear rules about contracts have made the contracts an optimal instrument in the Islamic finance. They have existed ever since the early days of Islamic finance, when there were no Islamic Financial Institutions.

At the beginning of Islam, businesses through partnerships were quite frequent. Business was based on 'credit instruments' and it was the good name that ruled the credit abilities. People with good reputation – normally through high social status – bought goods on credit and resold them later on. The business relations were as good as always based on already existing personal relations, but the social position of the business partners was also of great importance.

The risk sharing is very important within Islamic finance. The Shari'a manages this risk sharing by insisting on the use of well-defined contracts when financial transactions take place. The contracts are to be clear and well formulated to avoid all kinds of misunderstanding and confusion. It also fulfils its purpose to stabilise future happenings by connecting the unknown future to the known past. In this way the uncertainty is lowered and the desire to minimize the risk is met. (Al-Omar *et. al.*, 1996)

According to Al-Omar, there should in Islam not be a winner and a loser when doing business, but a partnership that will gain both parts.

Chapter Four

# 4. ISLAMIC FINANCIAL INSTITUTIONS (IFI)

*The Islamic Financial Institutions are shortly presented in this chapter.*

The use of the strong contracts in the Islamic world might have affected the late development of Islamic financial institutions (IFI) – simply because they were not needed. The religious and legal system in the Middle East was strong and adaptable to various kinds of situations. Specific Shari'a-based contracts for trade and business were used in the Islamic East for centuries and upheld by the legal courts. This standardisation of contracts made it possible for Muslims to finance huge projects and international trade even without intermediaries as banks. Instead western financial institutions were introduced in many Arab countries. (Warde, 2000)

The Islamic Financial Institutions did not start to develop until in the Mid-1970s. According to Archer, three main reasons caused the late development. First, political independence was achieved in those nations during the 1950s and 1960s. Second, awareness of an Islamic identity was rising. Thirdly the wealth grew in the Middle Eastern countries, due to their oil production which caused a great need for financial intermediation. Conventional financial institutions mainly outside the Middle East and Islamic countries handled the investments of the so-called petro-dollars. (Archer *et. al.*, 2002)

The earliest IFIs were mainly working in commercial banking activities. During the last two decades other forms of IFIs have developed. The majority of IFIs are Islamic banks which operate worldwide in both private and public sectors The IFIs can be grouped into broad categories according to the services they offer. The categories are the following:

-Islamic banks

-Islamic windows

-Islamic investment banks and funds

-Islamic mortgage companies

-Takaful companies (Islamic insurance institutions)

-Mudaraba companies

-International Islamic financial markets

Today there are more than 250 Islamic financial institutions worldwide managing assets in excess of US$200 billion. (Archer *et. al.*, 2002)

**Chapter Five**

# 5. THE ISLAMIC BANKING SYSTEM

*The environmental background and different categories of Islamic banks are described. The concept of Islamic Banking is presented as well as the aims and activities of Islamic banks in general. This is followed by discussions about interest/riba, why it is prohibited and the different interpretations of the meaning of riba. Furthermore the different accounts are presented and the chapter ends with a description of the financing alternatives offered by the Islamic banks.*

## 5.1. INTRODUCTION

It is hard to pinpoint the start of Islamic banking. Although financial transactions had existed for a long time, there was, until the 14th century, no institution exclusively devoted to banking. As mentioned above, one explanation for the late development of Islamic financial institution could have been the powerful role of the existing contracts. Another interpretation of the reasons why Islamic banks did not develop in the Islamic world is that it had to do with the structure of economic life. For one thing, Warde argues, finance was never an autonomous activity; it was always a subset of commerce. Financial relationships were to a much greater extent embedded in personal and communal ties in the Islamic world compared to the European economies of the late Middle Ages.

### 5.1.1. Environmental background

Western banking arose as a combination of two factors: the generation of capital by means of deposits of the many on the one hand, and money lending and the provision of credit for the few on the other. In the Islamic world, there was a disconnection between deposit and credit, and the conversion of deposits into loans was therefore not necessary. Credit and financing operations were conducted through transactions, usually involving profit-and-loss sharing and, therefore, unrelated to safekeeping. (Warde, 2000)

Al-Omar claims that theoretical discussions and articles on Islamic economics and banking led to the pioneering experiment in Egypt in 1963 (Al-Omar *et. al*., 1996).

The experiment was based on the *mudaraba* principle and lasted until 1967 – by that time there were nine banks involved. The non-interest banks invested mostly in the trade and industry sectors. The banks were not called Islamic banks for political reasons; since the regime in Egypt feared it might be associated with fundamental currents within the country. The banks were established to win the confidence of farmers and workers in Egypt. Those people were more religious and traditionally minded and shared no confidence in the secularised banks, which were run according to Western laws. In Cairo and Alexandria, though, the Islamic banks had less success when competing with the secularised banks. However, in 1967 the Islamic banks were shut down for political reasons. (Samuelsson, 2000; Zineldin, 1990)

### 5.1.2. Different categories of Islamic Banks

There are five categories of operating Islamic banks (Al-Omar *et. al*., 1996 p 22):

- The Islamic Development Bank. See further page 77
- The banks which operate in countries where the whole banking system is overseen in some way by religious bodies (like in Pakistan)
- The banks which operate in Muslim countries and which co-exist with interest-based banks (for example in Jordan, Egypt, Malaysia)
- Islamic banks in non-Muslim countries whose monetary authorities do not recognize their Islamic character (like the Al-Baraka International Bank in London and the Islamic Bank in Durban, South Africa)
- Islamic banks which exist in non-Muslim countries whose monetary authorities do recognize their Islamic character (for instance the Faisal International Bank (FIB) based in Copenhagen, Denmark, registered under the Danish Banking Supervisory Board)

## 5.2. THE CONCEPT OF ISLAMIC BANKING

The Islamic bank is a mix of commercial bank and investment bank. The banking operations must be compatible with Islamic norms. Furthermore they must be viable and profitable overall because the system must protect the depositors and give them an adequate rate of return.

Islamic banks´ general objective is to develop the economy within and according to Islamic principles. The banks can therefore under no circumstances engage in the payment and receipt of interest, in alcoholic beverage trade, in the gambling industry or in the pork meat trade, or any other activities explicitly prohibited by the Shari´a. (Al-Omar *et. al.*, 1996)

Islamic banks operate on the basis of profit and not on paying and receiving interest. The banks can earn profit from three areas: trading, leasing and by direct financing in Profit-and-Loss-Sharing contracts. Different instruments are devised to earn profit in any of these ways. The structure and conditions of these transactions must conform to the Shari´a and fulfil its desired objectives. This means that Islamic banks can extend loans only if interest or return is not earned on it. The only way to finance consumption activities, if at all, is through cost plus the capital, since there is no profit to be earned or shared. The banks advance money for commercially productive activities on the basis of profit-sharing principles. (Al-Omar *et. al.*, 1996)

There are four principles of special importance for Islamic banking (Al-Omar *et. al.*, 1996, p 24)

1. There must be some risk, whether funds are used in commercial or productive venture
2. All funds should preferably finance socially productive activity:
3. Financial risk must lie solely with the lender of the capital and not with the manager or agent who works with the capital;
4. Interest is forbidden in that it is a predetermined, fixed sum owed to the lender irrespective of the outcome of the business venture in which the fund is used.”

The Islamic banking system aims at developing new financial instruments to deal with the problems of the Muslim communities. This can be done by mobilising internal resources into a banking system conforming to Islamic teaching and principles. The main objective is to make the financial system an efficient medium for intermediation between savings and investments. (Zineldin, 1990)

The relationship between the bank and its clients is not the same for Islamic banks as for conventional banks. In the former it is one of direct trading or equity participation while in the latter it is that of lender/borrower. Islamic banks do not trade in debts as conventional banks do.

Suggestions have been made by some Muslim writers that the financial intermediation sector should be nationalized. However, very few share this opinion. Nationalization in general is not an authentic Islamic policy. It is considered to violate the basic Islamic philosophy of free will and respect for private property. (Al-Omar *et. al.*, 1996)

### 5.2.1. Aims of Islamic Banks in general

Prince Muhammed al-Faisal al-Sa´ud from Saudi-Arabia has said the following about the aims of the bank Dar al-Mal al-Islami/Faisal Group (DMI). The following list can be seen as rather representative of what Islamic banks state as their goals.

1) "To undertake all financial operations required by Muslims today in the framework of the principles and precepts of the Shari´a.
2) To implement its (DMI's) various activities through subsidiaries to be established in Islamic and other countries.
3) To invest, within an Islamic context, the funds of Muslims to generate licit profits.
4) To promote and consolidate co operations among Muslims." (Ray, 1995, p 16)

Ray suggests two additions to the list. The first is to promote economic and social development in Muslim countries. The social aspect has been implemented through the alms giving/zakat and creation of funds which Islamic banks employ (on a limited scale) in charitable works. On the whole, Islamic banks have achieved significant success in economic development by using participatory financing methods such as mudarabah, musharakah and (rarely) interest-free loans. The other aim must be the main motivating principle behind Islamic banking; to mobilise the capital of the hundreds of millions of Muslim farmers, artisans, shop owners, and other relatively poor people who have never put their savings in banks. (Ray, 1995)

The norm for an Islamic bank is to assess the profitability of a project and back those projects which promise the highest rate of profit, are the safest and the most socially beneficial. The primary basis on which the projects for PLS funding are selected is their anticipated profitability rather than the credit-worthiness of the borrower. (Al-Omar *et. al.*, 1996)

The profits made by the bank are shared in two steps. First the profit is shared between the bank and the business partner and then the bank's profit is shared between the bank and the holders of investment deposits. Let us say that the profit in the business venture is $ 20.000 and the profit-sharing ratio is 50 per cent each. The bank would then get $10.000 and the business partner $10.000 as a compensation for his successful work with the bank's capital. Clients with investment accounts are entitled to a share in the profits of the activities done by the bank. The profit-sharing ratio might be 40-60, that is 40 per cent of the profit goes to the bank and 60 per cent is given to depositors. This means that $ 4000 stays with the bank while $ 6000 is given to the depositors. (Zineldin, 1990)

**5.2.2. Activities of Islamic banks**

Every bank must offer various accounts to attract different customers. Not all customers have the same needs and wishes. The range of customers varies from personal customer, business people, official customers, organisations and clubs to societies. (Zineldin, 1990)

Some conventional bank activities are not conducted in Islamic banking. Interest, in all forms, is rejected by the participants in modern Islamic banking. This includes bonds, bank deposits, and certificates of deposits and the discounting of commercial paper. Islamic banks can deal with commercial paper at it initial stage, or to collect/accept it at face value. The majority of Islamic banks forbid the purchase of stock in companies dealing with interest (including Western companies). Exceptions do exist; for instance banks as al-Baraka accept trading of stock in Western firms. (Ray, 1995)

Currency futures cause diversity among the Islamic banks; some forbid them while others distinguish between two cases. The first case is where one currency is paid on a spot basis and the other delayed; this is forbidden. The second permitted case involves the future exchange of both currencies at the previously agreed rate. Future trading in commodities is forbidden for gold and silver, but not for other commodities. According to Ray currency options should be forbidden since it is necessary for currencies to change hands without delay. Ray further argues that commodities or shares options are acceptable in principle, but there is debate as to whether or not they can be traded to third party. (Ray, 1995) Charges on issuing travellers cheques and transferring money are also permitted is some banks. (Saeed, 1996)

## 5.3. INTEREST/USURY – *RIBA*

### 5.3.1. Introduction

In the Koran, both payment and receipt of interest (*riba*) is prohibited and considered a sin. No specific reasons for the prohibition are mentioned in the Koran. The absolute prohibition of interest in the Koran is a command to establish an economic system in which no forms of exploitation or unjustified enrichment are present. The main injustice with interest is that the financier is assured of a positive return without doing any work or sharing in the risk, while the entrepreneur, in spite of his management and hard work, is not assured of such a positive return. The prohibition of interest is a way to establish justice between the financier and entrepreneur. Money can be lent lawfully only for either charitable purposes or for the purposes of doing lawful business. By charitable purposes is meant a loan without any expectation of interest and by lawful business is meant investment that seeks profit while sharing the risk. (Al-Omar *et. al.*, 1996; Zineldin, 1990)

### 5.3.2. Reasons for the prohibition of interest – *riba*

According to Warde there are three main justifications for the prohibition of *riba* and these are strongly related to each other;

1) Riba is unfair, 2) Riba is exploitative and 3) Riba is unproductive.

1) Traditional borrower-lender relationship is based on interest. The borrower has the chance to receive all the profit or the risk to face all the losses that occur. The lender earns money no matter what the outcome of the venture may be. (Warde, 2000) Equity is another reason why the concept of interest is rejected. The rich have a surplus of money while the poor and needy are the once forced to borrow. Interest can therefore be seen as rewarding the rich and penalising the poor. (Naser & Moutinho, 1997; Akacem & Gilliam, 2002)

2) Riba is seen as exploitative since it favours the rich with a surplus of money and punishes the poor and needy who are forced to borrow. Islam emphasises risk sharing in business ventures. The profits or losses should be shared between the borrower and the lender. Lenders should be entitled to a share from profits from any venture they have helped to finance. (Warde, 2000; Akacem *et. al.*, 2002)

3) The issue of fairness is related to the issues of efficiency and productivity. Money should be used in economic ventures and contribute to the economy and enhance welfare. Abstaining from consumption, thus saving money is not an act that should be rewarded. In Islam the idea of getting a return for money only deposited in a bank is unacceptable. To justify reward the savings must be turned into productive use in thereby contribute to the economy with risk-sharing as a part, according to the teachings of Islam. (Akacem *et. al.*, 2002; Warde, 2000; Naser *et. al.*, 1997)

The Islamic banking system put an emphasis on the non-payment of interest as well as partnership and risk sharing. Interest is a guaranteed fixed and risk free rate of return. The Islamic banking system is built on a profit or loss system (PLS.). The Islamic bank and the borrower enter into an agreement. Profits or losses are shared between the parties according to an agreed-upon ratio. Instead of interest rates, expected rates of return from projects or investments are used. Returns should not be fixed regardless of profits, but a result of the profits and losses incurred in the venture. (Akacem *et. al.*, 2002)

According to Shari´a there are two kinds of bonuses. It is necessary to differentiate between them, on the one hand, an obligation to add a certain bonus after a certain term and, on the other hand, a non-obligatory addition of a bonus. When the bonus in non-obligatory there is no violation of Islamic law. If the depositor has a right to demand a bonus after a certain term, this amount is *riba* and is considered a serious violation of Islamic law. (Al-Omar *et. al.*, 1996)

### 5.3.3. Different interpretations of the meaning of *riba*

The question 'What exactly is riba?' concerns very many scholars. Literally, the word means increase, addition, expansion or growth. The Shari´a term riba refers to the premium that must be paid by the borrower to the lender along with the original amount of money as a condition for the loan or for an extension in its maturity. According to Warde riba really refers to any unlawful gain derived from the quantitative inequality of the counter values. Interest or usury is only one form of riba. (Warde, 2000; Al-Omar *et. al.*, 1996)

The injunctions against riba are the cornerstones of Islamic finance. However, a lot of debates are going on as to the exact significance of the word. These debates have divided the scholars; some are against all kinds of interest while others allow reasonable interest. The majority of them uses a restrictive definition and considers every form of interest a riba. Any increase in the amount of money returned by a borrower is considered riba and is therefore prohibited. The discussion whether all kinds of interest are riba partly evolves around the issue of inflation. Some scholars claim that Islam allows a reasonable rate of interest and considers only usury to be riba. If reasonable interest is allowed the prohibition would then apply to real interest (that is, the interest rate minus the rate of inflation) as opposed to nominal interest. Under inflation the value of the depositors' own money will fall through time. The absence of interest in an inflationary period would result in negative real interest, which would subsidise borrowers and penalise lenders. (Warde, 2000; Zineldin, 1990)

### 5.3.4. Summary

Both payment and receipt of interest are considered a sin in the Koran. The prohibition is a means to avoid exploitation and injustice. Interest is seen as unfair, exploitive and unproductive. The poor are usually the ones forced to borrow and they are forced to pay interest whether or not the business venture is successful. The rich can earn a rather risk-free profit without performing any actual labour.

## 5.4. DEPOSIT ACCOUNTS

### 5.4.1. Introduction

The opening of an account in an Islamic bank represents something different then the ordinary debtor-creditor relationship as it is in the Western banking system. In Islamic banks it is seen as a partner relationship. The whole Islamic banking system is built on a partnership basis in which the depositors, investors and borrowers participate. (Zineldin )

The main source of the bank's funds consists of the accounts available to the customers. All literature discusses the same three accounts while Al-Omar adds a fourth specific account; Special investment accounts. The main accounts are the following (Zineldin, 1990; Akacem *et. al.*, 2002; Al-Omar *et. al.*, 1996):

1) Demand Deposit Account (Current or Checking Accounts)
2) Savings Accounts
3) Investment Accounts
4) Special investment Accounts

### 5.4.2. Current, Checking or Demand Deposit Accounts

In the Demand deposit account the deposits can be withdrawn on demand without any conditions and restrictions. The main motive for customers to open an account of this kind is to keep excess liquidity available on demand, and not to earn any profit or income. Naturally, the bank does not pay any interest on these deposits. (Zineldin, 1990; Warde, 2000)

The bank provides the clients with chequebooks and other usual services connected with current accounts. Some of the Islamic banks charge a service fee for providing such a service. (Zineldin, 1990; Saeed, 1996; Al-Omar *et. al.*, 1996)

The nominal value of the deposits would be guaranteed and can therefore be seen as a completely safe financial asset, which would satisfy the demands of risk-averse customers. There are restrictions imposed on how the capital can be used. It cannot be used for risky ventures and will not be invested for making loans or investment and other securities. They can be used to make very short-term loans to parties who run out of liquidity. If the bank intends to use these funds while they remain with the bank it must ask for their clients´ permission. The profit, that the bank generates while using these funds, belongs to the bank. (Al-Omar *et. al.*, 1996; Zineldin, 1990; Akacem *et. al.*, 2002)

### 5.4.3. Savings accounts

Customers who want to save some funds and to earn some income mostly use the savings accounts. The motive is precautionary. The funds can be withdrawn at any time and are usually used in short range investment projects and ventures. The bank or the government guarantees the nominal value of the deposits. Some profit rate is usually paid to the depositor. However, any positive rate of return is not guaranteed. The depositor will not receive any premium if the bank incurs a loss on its investment projects. (Zineldin, 1990)

Some banks consider this sort of account to be in the category of investment accounts rather than saving accounts. (Al-Omar *et. al.*, 1996)

### 5.4.4. General Investment Accounts – *Mudaraba accounts*

General Investment accounts are also known as Profit-and-Loss Sharing Deposits. The most important source of funds and earning activity for Islamic banks is the investment accounts. The motive is to earn a profit rather than holding funds for precautionary or transaction reasons. An investment account offers a higher portion of the rate of return than the ordinary deposit account in return for a higher risk from investment operations (Akacem *et. al.*, 2002; Zineldin, 1990).

The only guarantee that the holder of an investment account receives is the profit and loss ratio, how profit and losses are to be shared between the bank and depositor. This ratio is agreed upon in advance and cannot be changed during the life of the contract (Akacem *et. al.*, 2002).

The holder of the account can be entitled to a share in the profit of a single project or a general share in all activities excluding earnings from banking and other services. Deposit holders normally have no saying in the management of the bank and in most cases do not participate in the management of investing the funds. The funds are invested in economic projects or sectors that follow Shari´a principles. The nominal value of the capital is not guaranteed and the bank pays no interest on the capital.  The depositors receive a share in the profit made by the bank. Even losses are shared between the bank and the depositors, but according to Al-Omar the client bears all the losses if the investments are not profitable (Al-Omar *et. al.*, 1996; Zineldin, 1990).

### 5.4.5. Special Investment Accounts

In addition to the general investment accounts, the banks may also offer special investment accounts. These are often offered selectively to wealthy individuals or corporate clients. These accounts also follow the principles of Mudaraba. The difference is that the modes of investment of the funds and the distribution of profits may (and usually are) negotiated individually (Al-Omar *et. al.*, 1996).

### 5.4.6. Summary

The relationship between the Islamic bank and the client is a partnership and not a debtor-creditor relationship. The bank’s main source of funds is the accounts available to the customers. The general characteristics of the accounts are the following:

**Table 5:1**

Available Accounts – An Overview

| Accounts | Purpose | Nominal Value Guaranteed | Profit | Risk |
|---|---|---|---|---|
| Demand Deposit Account | Keep excess liquidity available on demand | Yes | None | None |
| Savings Account | Precautionary, to earn some profit | Yes | Usually paid to clients but not guaranteed | Low |
| General Investment Account | Earn a profit | No | From a single project or general share in all activities | High |
| Special investment Account | Earn a profit exclusively for wealthy clients | No | As negotiated with the bank | High |

## 5.5. FINANCING ALTERNATIVES

### 5.5.1. Introduction

Islamic banking is based on two techniques that fully satisfy the Shari´a. These two methods of investment are called risk-return sharing are known in Arabic as Musharaka and Mudaraba.

New techniques or instruments have also been adopted to meet particular needs in modern business where interest has traditionally been the only solution.

These new techniques are

*-Murabaha (cost-plus-profit contract)*

*-Other Mark-up schemes*

*-Ijara (leasing)*

*-Ijara wa-iqtin´a (hire purchase contract)* (Zineldin, 1990)

### 5.5.2. Capital Trust Financing – *Mudaraba*

Mudaraba is also known as Commenda Partnership and Finance Trusteeship. The contract or the arrangement of Mudaraba is actually an arrangement to provide an Islamic solution to the economic dilemma of how the supplier of capital or monetary assets and the entrepreneur who uses the investable fund, according to his abilities and thus experience and expertise, can be brought together on common ground.

The entrepreneur manages the investment venture, but the bank can choose to take practical part in the running of the project(s). The bank also has the right to follow up the operating business through audit and advise the partner with important information. (Zineldin, 1990)

Mudaraba certificates can mature at call, at fixed interval after issue or at a fixed date. The holder of a Mudaraba certificate is entitled to share in the profits of the investment activities being undertaken by the company. Risk capital for the company can be provided by banks in the form of direct equity, or through loans with equity features. Agreements can be made between the two parties concerning for how long a period of time the capital can be used and if it is only intended for a specific project. Once the project or the time period has ended the entrepreneur returns the money to the investor. Besides that, the investor also receives his pre-agreed share of the profit. The entrepreneur keeps what remains of the profit for himself as a compensation for his work and expertise. Should the venture be unsuccessful, the capital provider alone must bear the financial losses. The liability of the investor is limited to the amount of capital he has paid. The entrepreneur loses his reward for the time and effort spent, but he does not have to bear any financial loss under the condition that he has not been negligent. The risk of total loss, through mismanagement or negligence, is forbidden. The entrepreneur is obliged to repay the original sum of capital to the owner in case the entrepreneur is or has been negligent. (Zineldin, 1990)

This pre-agreed profit-sharing ratio should not be mixed up with the return on money-lending, interest, which is prohibited. The interest is pre-determined while the profit is not. Therefore the share of the profit cannot be pre-determined.

The depositor or the investor cannot require a guarantee against the risk that the investment is lost in part or totally. If this happens, such an investment does not qualify as a trust financing or commenda contract. Mudaraba is and must be a combination of business activity and commercial risk taken by the capitalist. (Zineldin, 1990)

### 5.5.3. Equity Financing – *Musharaka*

The Musharaka financing contract means that a capital-owner finances investment in another party's business. The capital is provided on the condition that the capital-owner shares the profit from the business. (Al-Omar *et. al.*, 1996)

This profit-sharing joint venture is usually designed for limited production or commercial activities of long duration, whereby the bank and the customer contribute capital assets as well as technical and managerial expertise in varying proportion, for a specific project. These profit-sharing arrangements may be applied either to the whole enterprise, where each partner takes an equity position, or to a particular line of activity within the enterprise; that is, they can have either whole-firm or project-specific orientations. (Zineldin, 1990)

The profit-sharing ratio is predetermined and fixed and known to all concerned. The capital-owner and entrepreneur agree upon the ratio and it may be different from the ratio in which the two parties have invested in the total capital of the project. The reason for this is that the two parties may share the work of managing the project in any amount mutually agreed upon. Both parties are allowed to charge a fee or wage for any management or labour put into the project. All providers of capital have the right to participate in management and audit operations but are not required to do so. The losses are shared according to the exact proportion of capital contribution ratio without any modification. (Al-Omar *et. al.*, 1996; Zineldin, 1990)

### 5.5.4. Comparison between Mudaraba and Musharaka

Mudaraba and Musharaka are very similar because the provider of finance shares the profit directly and is contracted to bear the losses, if any, to the extent of his investment. These two techniques are therefore often characterised as profit-and-loss-sharing (PLS). In Islamic banking, with the replacement of interest by PLS from the return of the capital advanced by the banks, repayments depend entirely on the productivity of the projected enterprise. The norm for an Islamic bank is to assess the profitability of a project and back the projects which promise the highest rate of profit, are the safest, and socially the most beneficial.

The primary basis on which the projects for PLS funding are selected is their anticipated profitability rather than the credit-worthiness of the borrower. There is an important difference between the Musharaka and Mudaraba. In the Musharaka contract both parties bear the losses, if any. In Mudaraba, the bank or investor alone bears the losses. (Zineldin, 1990; Al-Omar *et. al.*, 1996)

**Table 5:2**

Financing Alternatives – A Comparison

| | English | Capital supplied by whom | Profit shared | Losses shared |
|---|---|---|---|---|
| Mudaraba | Short-term financial credit | Bank / Investor | According to agreed-upon ratio | No, Capital provider alone bears losses. |
| Musharaka | Longer-term equity arrangement | Bank **and** client | According to agreed-upon ratio | Exactly according to capital contribution |

### 5.5.5. Cost-plus profit/Mark up – *Murabaha*

Murabaha, or mark up purchase, is short term financing. It takes a leading role as an Islamic financial instrument. According to Warde the Mark-up transactions account for 80 to 95 per cent of all investments by Islamic financial institutions and Henry claims that financial contracts based on murabahah constitute more than half of the assets of Islamic banks. (Zineldin, 1990; Warde, 2000; Henry & Wilson, 2004)

By using the Murabaha Islamic banks can enter into the trade cycle. The banks can enter as buyers of raw materials, goods, equipment or any other assets. The merchandise will later be sold to a client at cost plus a negotiated profit margin on the basis of deferred payments. Both parties must know the original price and the profit rate. The price of the commodities or assets is agreed upon between the bank and the client at the time of the sale and cannot include any charges if payments are not made on time. The rate of profit should not be tied to the length of the period over which the financing is to be provided. The price of the sale should not be increased under any circumstances; if the customer makes a late payment he should not be penalised with an extra charge.

The mark-up is not a compensation for time or deferred payment. The mark-up is for the service that the finance-owner provides. These services include seeking out, locating and purchasing the required goods at the best price. This service is recognised and can be paid for since its value is pre-determinable. (Al-Omar *et. al.*, 2002; Zineldin, 1990)

When a client wishes to use this method he requests the bank to buy a certain asset at a specific price. The client promises to buy it from the bank at a set time and at the higher price. The agreement of the bank to buy or the purchase itself does not oblige the client to buy the asset, all according to Shari´a. However, according to Ray, most banks consider the promise to purchase binding. They also require collateral against the deal is not kept. (Ray, 1995; Zineldin, 1990; Al-Omar *et. al.*, 1996)

There are certain conditions that justify the finance-provider to charge a fixed mark-up. By obtaining the goods for his client he provides a definite service. For this service he can charge a fixed price. The client is not, as mentioned above, obliged to buy the asset from the bank although this has been agreed upon. Arguments have been made that the finance-provider does not bear any risk when buying the goods but the element of risk is undoubtedly there. Customers have the right to refuse buying the goods after the bank has purchased it and then the financier cannot sell the goods as planned. Should this be the case the bank must sell it in the market place. If this is done with a loss the bank must bear all the costs alone. Although the mark-up is fixed that bank cannot be certain of actually making the profit. The main disadvantage of Murabaha is the bank must make sure that the goods are marketable since it may have to resell it to a third party in the marketplace. (Zineldin, 1990; Al-Omar *et. al.*, 1996)

**5.5.6. Other mark-up schemes**

There are a number of variations on the basic idea of Murabaha. They are as follows (Warde, 2000):

1) Bai Muajjal (Credit sale or Sale on a deferred-payment basis)
2) Bai Al-Salam (Advance payment or Foreward buying)
3) Bai Istisna (Commisioned manufacture)

#### 5.5.6.1. Credit sale/Sale on deferred payment basis – *Bai Muajjal*

The Bai Muajjal financing technique is based on mark-up in price and is also known as murabahah. This transaction is a sale and not a loan. The goods are delivered immediately. The price must be agreed upon at the time of the bargain and it is paid at a given time in the future. The price includes the cost plus a margin of profit to cover administrative costs and it cannot be changed even if the payment is not made at the due date. The creditworthiness of the purchaser is the only guarantee of timely payment. (Al-Omar *et. al.*, 1996; Warde, 2000)

#### 5.5.6.2. Advance Payment/Foreward Buying – *Bai Al-Salam*

Bai Al-Salam is a trade transaction. The financier agrees to purchase a commodity from the producer. The kind, quality and quantity along with the agreed price of the commodity must be specified as well as the time and place of delivery. The agreed price is paid in full in cash at the time of the contract. The commodity will be delivered to the purchaser at a future date. Risk therefore generally stays with the seller until the time of delivery. The purchaser in the salam sale has the right to inspect the goods. He may reject the goods on sight if they do not agree with their description as specified at the time of contracting. This method is not widely used yet, but according to Warde it has great potential in certain areas, such as agricultural products. (Al-Omar *et. al.*, 1996; Warde, 2000)

The goods must be of a type commonly available at the time fixed for delivery; the contract may not specify delivery of goods from a certain plot or location. These conditions have to be met to protect the financier against unnecessary risk. At the same time it makes it possible for the producer to deliver the produce from another source, if needed. When doing that the conditions on quantity, quality and kind must be met. As opposed to what *Warde* suggests, *Al-Omar* claims that Islamic banks have not used (do not use) this kind of sale transaction to finance the agricultural sector. This could be because the practical problems connected to it; taking delivery of the produce, assessing its quality, and then storing and disposing of it. (Al-Omar *et. al.*, 1996)

There are certain conditions that must be met to make these future sales contracts valid. The goods are not available or cannot be delivered at the time of the contracting. The consideration must be paid or the rate of it fixed when the contract is concluded. If the buyer's consideration is in the form of a set-off or negotiation the contract will be void. Any interchangeable object of a *salam* sale must be determined precisely as to kind, quantity and quality. For instance, precious stones and valuable paintings which are unique are considered non-fungibles. They are not permitted to form the objects of *salam* sales, since by their nature they cannot comply with the conditions of determination. (Al-Omar *et. al.*, 1996)

#### 5.5.6.3. Commisioned Manufacture – *Bai Istisna*

Bai Istisna is a new concept in modern Islamic finance and it is an agreement for processed goods and commodidties. It offers a number of future structuring possibilities for financing and trading. This agreement allows cash payment in advance and future delivery as well as future payment and future delivery. These choices give the lender some flexibility. He can pre-sell to his client for future delivery on a cash-on-delivery basis and then negotiate the purchase. (Warde, 2000; Al-Omar *et. al.*, 1996)

Al-Omar claims that Istisna will play a large role in the short-term investment and working capital schemes in the future. Furthermore he claims that it will replace the Murabahah as the short-term financing scheme, especially when used in international trade. (Al-Omar *et. al.*, 1996)

Two main criticisms have been expressed on mark-up schemes. The first one is that they are low-risk and short-term. Thereby they do not fulfil the purpose of Islamic banking which is to share risk with the borrower. The bank only bears minimal risk and the profit margin is predetermined. The purchased asset is a guarantee and some banks may even require the client to offer collateral. The second criticism is that mark-up schemes are nothing more than copies of techniques used by conventional banks. The interest is simply disguised under other names. The question is what the nature of the bank's remuneration really is.

If it is a “lending fee” then it is the same as interest, but if it is remuneration for the service provided or for the risk incurred then it is acceptable. (Warde, 2000)

### 5.5.7. Leasing – *Ijara*

Leasing is allowed under Islamic law and it is a contract based on profit sharing between the bank and the client. It is one of the tools most used in cooperation with international financial institutions and Warde states that it could be the fastest growing activity of those. (Zineldin, 1990; Warde, 2000)

Leasing is a financing technique. The bank can buy an asset, machinery or equipment and then rent it to a client. The leasing is done for an agreed-upon sum by instalments and for a mutually agreed-upon limited period of time into a savings account held with the same bank. (Zineldin, 1990; Al-Omar *et. al.*, 1996)

These conditions must be met in order to follow Islamic law:

“- The service that the asset is supposed to provide and for which it is being rented should be definitely and clearly known to both parties;

- The asset remains in the ownership of the lessor who is responsible for its maintenance so that it continues to give the service for which it was rented;
- The leasing contract is terminated as soon as the asset ceases to give the service for which it was rented. If the asset is damaged during the period of the contract, the contract will remain valid;
- The price of an asset that may be sold to the lessee at the expiry of the contract cannot be pre-determined. It can be determined only at the time of the expiry of the contract.” (Al-Omar *et. al.*, 1996, p 14)

### 5.5.8. Leasing and Purchase – *Ijarah-Wa-Iqtin’a*

The Ijara-Wa-Iqtin’a means a hire-purchase agreement between the bank and its clients. It is a variation on the basic principle of leasing. The bank agrees to buy and rent equipment, building or a facility to the client, who makes incremental payments into an account.

At the end of each year, profits generated by the asset employed by the client are added to the instalments paid until the investment account contains the same amount the bank paid to purchase the equipment, building or facility. At the expiration of the lease, the lessee becomes the owner of the asset (Warde, 2000; Al-Omar *et. al.*, 1996).

The amount of rent collected from the lease; i.e. the bank's return, is not calculated on the basis of the bank's capital involved. It is calculated on the profitability of the asset once it is employed by the client. In other terms, the rent is related to business success (Zineldin, 1990).

**5.5.9. Summary**

The Islamic banks do not offer customers financing through interest-based loans. Other techniques are used such as mudaraba and musharaka. The banks also function as a middleman by using mark up schemes which includes purchasing assets that are later resold to clients. This can be done in alternative ways all based on the basic idea of murabaha, which is short-term financing and takes the leading role as an Islamic financial instrument. The mark up schemes can be done on different conditions. These are the general characteristics of Bai Muajjal, Bai Al-Salam and Bai Istisna.

**Table 5:3**

Different Mark Up Schemes – An Overview

| | English | Price Agreed-upon | Price Paid | Goods delivered |
|---|---|---|---|---|
| Bai Muajjal | Credit Sale/ Sale on deferred-payment basis | Yes | At given date in the future | Immediately |
| Bai Al-Salam | Advance Payment / Foreward Buying | Yes | Immediately, at time of contract | At a specified future date |
| Bai-Istisna | Commissioned Manufacture | Negotiable | Cash payment / Future payment | Future delivery |

Leasing is another financing technique acceptable according to Islamic law. The bank buys the asset and rents it to the clients. This is done for an agreed-upon sum and a limited period of time. Leasing and purchase is a variation on the basic principle of leasing. The difference is that at the end of the leasing period the lessee becomes the owner of the asset.

Chapter Six

# 6. IMPLEMENTATION OF ISLAMIC BANKING

*An Overview of the presence of Islamic banks in general is followed by descriptions of the Islamic Banking system's implementation in some selected countries.*

In order to create a broad picture of the current situation in Islamic banking, a few countries have been selected to highlight some specific characteristics of the implementation. An attempt has been made to cover different geographical areas including Northern Africa, the Middle East, the Arabian Peninsula and Southeast Asia.

## 6.1. Religious Background

There are different interpretations of the Shari'a, which explains the different schools of jurisprudence which have developed over the years. By the 10$^{th}$ century four main schools had emerged within the orthodox Sunni tradition – Hanafi, Shafii, Maliki and Hanbali. Every Sunni is in theory a follower of one of those schools. Over the years, each school found particular favour in certain localities, hence the geographical concentration of adherents that can be found nowadays.

a. Hanbalis are primarily concentrated in Saudi Arabia
b. Malikis predominate in North and West Africa
c. Shafiis are a majority in Indonesia, Malaysia, East Africa, Yemen, and parts of Egypt
d. Hanafi is the most widespread of them all and influential in Turkey as well as Egypt, Syria, Lebanon, Jordan and Iraq. It was once the official school of the Ottoman Empire (Warde, 2000, pp 32).

The Shia Muslims have their own separate schools, but since the Shia Muslims only form 10 per cent of the Muslim population, this dissertation will not present their schools further.

## 6.2. Present situation – an overview

The governments of the Middle East are encouraged to adopt policies of economic liberalization. This might result in a new type of capitalism emerging, not based on a Western Protestant ethic, but rather on Islamic beliefs and values. Many governments in the Middle East and North Africa (MENA) encourage and tolerate the development of characteristically Islamic financial practices. Many of the MENA countries are illiberal but they are normally less closed financially than politically. In some countries Islamic banks are tolerated as a part of the government's strategy to legitimate itself in the eyes of the religious public. (Henry *et. al.*, 2004)

Islamic capital is growing by narrow as well as broad definitions. Calculations have been made on the funds invested through the instruments acceptable by Shari´a and used by Islamic banks and other financial institutions. This capital grew at an annual rate of 10 to 15 per cent in the late 1990s. The value has been estimated to be over US$ 200 billion. Investors, most of who are in the Gulf Cooperation Countries (GCC), drive the growth. (Henry *et. al.*, 2004)

Ray divides Arab Islamic bank into five groups:

1) The Dar al-Mal al-Islami (DMI)/Faisal group
2) The Dalla al-Baraka group
3) Gulf Banks
4) Sudanese banks
5) Independent banks (Ray, 1995, p 9)

At the centre of the Islamic finance movement are two transnational groups opening new branches in a wide variety of countries. One is the Al-Baraka group. The second is the group of banks affiliated to Dar al-Mal al-Islami. The latter is a holding company controlled by Prince Mohammad Al-Faisal; son of the late King Faisal. The Gulf banks are largely independent of one another. (Henry *et. al.*, 2004)

The International Financial Corporation of the World Bank encourages co-financing infrastructure projects with the Islamic Development Bank.

Prominent construction and oil companies and other multinationals have used Islamic financial instruments in some project finance in the GCC states. Henry argues that Islamic finance is becoming respectable in international business circles. (Henry *et. al.*, 2004)

Very few Islamic countries employ a single Islamic banking system. Most Islamic and Arab countries have both the Islamic and the conventional systems of banking. Conventional banks even open Islamic windows, where Islamic activities are conducted. Islamic banks are absent from Oman, Iraq, Syria, Morocco and Libya. They have a marginal presence in Lebanon, Algeria and Tunisia. The banking systems in Iran, Pakistan and Sudan were all Islamized from above after 1979. Government banks have an official monopoly in Iraq and Libya. The situation was the same in Algeria until the mid-1990s and in Syria until 2001. This leaves little room for private financial banks, whether Islamic or conventional. (Naser *et. al.*, 1997; Henry *et. al.*, 2004)

**Table 6:1**

**Presence of Islamic Banks – Country overview**

| **No Islamic Banks** | **Islamic Banks** | | | | |
|---|---|---|---|---|---|
| | **Marginal Presence** | **Small Market Share** | **Medium Market Share** | **High Market Share** | **Government Legislation** |
| Iraq | Algeria | Malaysia | Bahrain | Kuwait | Iran |
| Libya | Lebanon | Turkey | Egypt | Qatar | Pakistan |
| Morocco | Tunisia | Yemen | Jordan | | Sudan |
| Oman | | | Saudi | | |
| Syria | | | UAE | | |

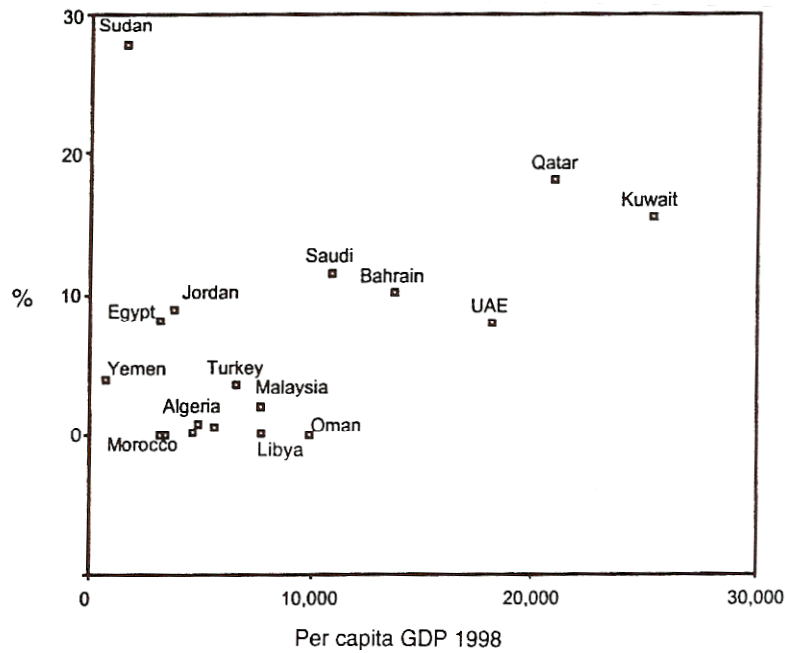
Islamic commercial banks can be both privately- and publicly owned. In some MENA countries privately owned Islamic commercial banks compete with conventional privately- and publicly owned ones. A comparison between the market shares of Islamic banks and conventional banks can be made. (Henry *et. al.,* 2004)

**Table 6:2**

Evolution of Islamic banks' share of commercial bank deposits by country, 1998-2001 (Henry *et.al.*, 2004 p 7, modified).

| | Year first establ. | 1986 | 1996 | 1997 | 1998 | 1999 | 2000 | 2001 |
|---|---|---|---|---|---|---|---|---|
| Egypt | 1977 | 9.7 | 5.1 | | | | 5.7 | |
| Iran | | 100.0 | 100.0 | 100.0 | 100.0 | | | |
| Jordan | 1978 | 7.0 | 8.4 | 8.2 | 8.0 | 7.5 | 6.9 | 7.1 |
| Kuwait | 1977 | 18.0 | 16.2 | 16.3 | 15.5 | | | |
| Lebanon | 1991 | | 0.1 | 0.0 | 0.1 | | | |
| Malaysia | 1983 | | 1.6 | 1.6 | | | | |
| Saudi Arabia | 1988 | | 11.3 | 11.1 | 11.5 | 12.3 | 13.9 | |
| Sudan | | 17.0 | | | 27.9 | | | |
| Turkey | 1985 | 0.8 | | 3.6 | 3.6 | 3.7 | 3.5 | 1.8 |

Sources: IMF International Financial Statistics, Harvard Islamic Finance Information Program, various Annual Reports of banks.

**Figure 6:1**
Islamic share of commercial bank deposits by per capita GDP, circa 1998.

Notes: Syria clusters beside Morocco, having no Islamic banking. Lebanon and slightly wealthier Tunisia lie just under Algeria and have minuscule market share. (Henry et. al., 2004, p 9)

Apart from Sudan, Islamic banking has developed the most in the richer petroleum producing countries. As seen in the figure above, GDP per capita seems to be rather closely related to the degree at which Islamic banks have entered into the commercial market. If Sudan is excluded, the wealthiest GCC states of Qatar and Kuwait outdo the others. If GCC is excluded, the relationship goes in another direction. The poor countries of Sudan, Egypt Yemen and Jordan show a higher market share than the richer states such as Malaysia, Turkey, Tunisia and Libya. The conclusion can be drawn that other factors, such as politics, population size and natural resources besides wealth could have an association with Islamic finance. (Henry *et. al*., 2004)

Politics puts up conditions for the Islamic financial institutions. The environment of banking has great effect on the banks and how and where they succeed. Heavily state-controlled environments may be less beneficial for Islamic banking than liberalized commercial ones with fewer restrictions. In some states Islamic banks have some trouble with politics. Governments, for instance in Tunisia and Algeria, have declared war on political Islamists. In those countries Islamic financial establishments do not prosper. Sudan is the one country in which Islamic banks financed an Islamist political movement and helped it to seize power for some time. Kuwait is an example of how extremely close relations there can be between an Islamist political movement and an Islamic bank. Jordan and Turkey are examples of the indirect connections and interactions between Islamic financial institutions and Islamic political parties and factions. Egypt is an example of a country where the regime represses its political Islamists but the Islamic banking is still accepted. (Henry *et. al.*, 2004)

### 6.3. Egypt

**Country facts**

| | |
|---|---|
| Population: | 78 millions |
| Religion: | Muslim (mostly Sunni) 94%, Coptic Christian and other 6% |
| Government Type: | Republic |
| GDP- ppp: | $295 billions |
| GDP- Real Growth Rate: | 3.1% |
| GDP- per capita, ppp: | $4,000 |

The Mit Ghamr savings/investment house in the Egyptian countryside is in general identified as the first Islamic bank in Egypt and in the world. Mit Ghamr was established in 1963 by Ahmed al Najjar and operated until 1973, when the Egyptian government liquidated the banks (by then the bank had grown to include eleven banks). The founder Ahmed al Najjar wanted to start an Islamic bank in Egypt based on the German saving bank model, which he had become familiar with during his studies in Germany. The Germans were also willing to support his project and by using family contacts, al Najjar managed to get the official stamp of approval from the government in Egypt. Interesting is, that al Najjar never made any reference to Islam during the process of founding the bank for fear that his project would be rejected in an anti-Islamic era.
Neither the state nor the public was informed that the motive behind the creation of the bank was an Islamic one. Still, the Mit Ghamr bank is recognised as the first Islamic bank, which inspired Islamists in other Muslim countries to establish Islamic alternative to the already existing economic and financial institutions. (Henry *et. al.*, 2004)

Henry argues that there is a difference between the very first Islamic banks and the Islamic banks of today. According to Henry, the first Islamic banks were created to fill a gap in social and economic life and to support the poor by increasing the population's awareness of saving and by mobilising their resources. The Islamic banks of today, on the other hand, seem to be based on the idea that all other banks – the conventional banks – are illicit and to be replaced by the Islamic ones. (Henry *et. al.,* 2004)

According to Henry and Zineldin, the first distinguished Islamic bank in Egypt is the Faisal Islamic Bank of Egypt (FIBE) which was established in 1979. FIBE is one of 44 commercial banks in the country and the largest financial institution and represents the dominant model. According to Zineldin, the number of Islamic banks operating in Egypt is still limited. FIBE is an Egyptian joint stock company and has from the start striven for inclusiveness and political respectability.

Among the bank's founders and shareholders are a wide spread of political, economic and religious figures FIBE's main objective is "to establish a modern banking unit which adheres in all its operations to the Islamic Shari'a." (Ray, 1995, p 85) (Henry *et. al.*, 2004; Zineldin, 1990; Warde, 2000).

Two other Islamic banks operating in Egypt today are, according to Henry, the International Bank for Investment and Development (IIBID) and the Egyptian-Saudi Investment Bank (ESIB). Both banks are together with the FIBE often referred to as private Islamic banks, but the state owns in fact between 20-80 per cent of each bank. The state has played an important role in the creation and promotion of Islamic banking, but has, at the same time, created doubt on the basic banking system, which is based on interest. By highly recommending the Islamic banking system and at the same time allowing interest-based banks, the state has presented itself as non-Islamic and sinful. (Henry, 2004)

According to Warde, Egypt is one of few Islamic countries where the top religious establishment has approved of interest-based lending. Yet, as many other countries, Egypt is quite typical in its government's suspicions about Islamic finance. The government worries about the risk that the Islamic sector might destabilize the state. (Warde, 2000)

Ray mentions the new and interesting phenomenon, that conventional banks in Egypt open so-called Islamic branches. By 1995 this new trend had grown to include eleven non-Islamic banks. The underlying motives for opening so-called Islamic branches, Ray states, are not only the desire to compete in a market opened by FIBE and other Islamic banks, but also an attempt to weaken strong Islamic banks such as FIBE. This phenomenon, however, will lead towards an Islamisation of the banking system as a whole. (Ray, 1995) Still, as Henry argues, Islamic banking has not in practice been the monopoly of the Islamic movement, nor the monopoly of its founders. Most of the people involved in Islamic banking business are apolitical and some of them move back and forth between Islamic and conventional banks. (Henry *et. al.*, 2004)

The same concepts and rules control all Islamic banks, which forms a similarity in the practice between the banks. According to Ray, FIBE also collects alms tax (*zakat*) on the shareholder's equity. The zakat fund provides aid for needy and sponsors Koran recitation classes. (Ray, 1995)

## 6.4. Indonesia

**Country facts**

| | |
|---|---|
| Population: | 238 millions |
| Religion: | Muslim 88%, Christian 8%, Hindu 2%, Buddhist 1%, other 1% |
| Government Type: | Republic |
| GDP- ppp: | $758 billions |
| GDP- Real Growth Rate: | 4.1% |
| GDP- per capita, ppp: | $3,200 |

Some 190 million Muslims, who account for some 90 per cent of the population, inhabit Indonesia. Yet, it was long assumed, that Indonesia was not ready for Islamic finance since there was a strong secular and multi-ethnic tradition in the country. Not until the 15th century did Islam reach Indonesia. A system of 'religious secularism' was used to balance the delicate ethnic, religious, political and economic situation. The motto 'unity through diversity' points out the importance of consensus. As the Islamist opposition arose, the President Suharto started courting religious leaders. Islamic groups began to focus on social programmes, education and moral guidance as a way to express their religious faith. Muslims replaced more and more Christian figures in the army and the government.

In 1990 the highest Muslim authority in Indonesia decided to establish an interest free banking system in the country. Two years later the Bank Muamalat Indonesia (BMI) opened. Its mission was to help the government in the process of national economic development, particularly in relation to small- and medium-scale entrepreneurship. Interestingly however, the shareholders of BMI are not limited to include Muslims only. In fact, most shareholders are non-Muslims. (Warde, 2000)

### 6.5. Iran

**Country facts**

| | |
|---|---|
| Population: | 69 millions |
| Religion: | Shia Muslim 89%, Sunni Muslim 9%, others 2% |
| Government Type: | Theocratic Republic |
| GDP- ppp: | $478 billions |
| GDP- Real Growth Rate: | 6.1% |
| GDP- per capita, ppp: | $7,000 |

Since 1979, Iran has been ruled by the Shi'it clergy, who came to power under the leadership of Ayatollah Khomeini during the 1979 Revolution. The name of the country was changed to the Islamic Republic of Iran and ever since, the national flag has carried the Islamic *shahada*, the Koranic statement of faith symbolising the Islamic nature of the republic. The new regime nationalised large segments of the economy, including banks. The religious establishment also controlled a number of 'foundations'; the most important of which was established with funds confiscated from the Shah's family and their followers. Although apparently created to help the poor, it was also a massive business enterprise – in fact Iran's largest holing company – controlling some 1,200 firms worth hundreds of millions of dollars. (Nomani *et. al.*, 1994; Warde, 2000)

The many disputes, the Iran-Iraq war, international sanctions, economic policy and the structural weakness of the Iranian economy affected the economic performance in a bad way. This enhanced the position of the advocates of a more liberal economic policy. The urban economy was in serious difficulties due to months of strikes of go-slows and the shortage of raw material and intermediary goods. Many owners and senior managers of the largest industrial enterprises, private banks and insurance companies had left the country and those who remained had lost confidence. The banking system was facing a crisis caused by massive with-drawals in the latter part of 1978. A further aggravating factor was the heavy debts owed by large industries to the banks.

The banking system was nationalised in 1979 and the Law of Usury-Free Banking was approved by parliament in August 1983. According to this law, banks perform the function of a profit-sharing institution. They can accept two kinds of deposits: interest-free deposits and term-investment deposits.

Term-investment deposits can be either short-term (three months) or long-term (one year). Banks can use their resources in investment projects, sharing the profit (or loss) with the depositors' funds, in which case the banks charge a commission.

In principle, the profits earned as a result of the banks' investment are to be divided among depositors after deduction of the banks' fees. The return is calculated in proportion to the total value of investment deposits, excluding the required reserves. In any case, the banks guarantee the return of the principal of these deposits, which makes the operation questionable from a strictly Islamic point of view. In addition, banks must announce their profit rate every six months, when the depositors' share of profits is due to be paid. Of course, if deposits are withdrawn before the minimum time required or reduced below the required minimum, no profit will be earned.

Term-investment funds can be used by banks in accordance with Islamic contracts, such as mudaraba, musharaka, direct investment, hire-purchase, forward transactions, credit sale in industrial, agricultural and the service sectors. Consumers can receive interest-free deposit loans and enter into credit sale contracts for consumption purposes. (Nomani *et. al.*, 1994).

Since 1984 Iranian banks have been operating under Islamic principles. The process of Islamisation from an interest-based to a non-interest based banking system started after the Revolution in 1979. According to Makiyan, the process went through three distinct stages. The first stage was the nationalisation of the banking system. At this stage commercial and specialised banks merged with each other and continued their operation under government supervision. Foreign banks were also closed in 1980, but later re-opened with limited operations. They were allowed to establish representative offices for advisory services. Further, the Iranian authorities prepared laws concerning how the banks should operate to create harmony between the Islamic Law (the Shari'a) and the banking system.

The second stage began in 1982 and lasted until 1986. During those years the legislation was introduced in order to adopt and implement a model of Islamic banking. In 1983 the law on interest-free banking was passed in the Parliament.

It forced the banks to convert their deposits according to Islamic principles within one year. The third and present stage started in 1986. At this stage the banking system was considered as an integral part of the Islamic government. The reduction in oil revenues together with a political intention to stop relying on external financial sources made the banking system play a role broader than the purely intermediary. Therefore, the banking system was used as an instrument for restructuring the economy. The expected rates of return on loans have since 1984 been heavily influenced by managing of the government and regulation rather than market information. (Makiyan, 2003)

### 6.6. Jordan

**Country facts**

| | |
|---|---|
| Population: | 5.6 millions |
| Religion: | Sunni Muslim 92%, Christian 6%, other 2% |
| Government Type: | Constitutional Monarchy |
| GDP- ppp: | $23 billions |
| GDP- Real Growth Rate: | 3.1% |
| GDP- per capita, ppp | $4,300 |

During the 1970s an extensive institutionalisation took place for Islamists in Jordan. The Islamic movements and Islamism as an ideology were very popular in the Arab World and in Jordan. During the civil war that ended 1967, the Muslim Brotherhood had chosen the monarch's side and had therefore received high status in the country. This gave them an opportunity to establish numerous new charitable, educational and healthcare institutions. The concept of Islamic economics and the establishment of Islamic financial institutions were discussed. The Islamists in Jordan were inspired by the Pakistani Islamists and by the Mit Ghamr bank in Egypt. As the Islamic Development Bank and the Dubai Islamic Bank were established in 1975, it encouraged the Jordanian Islamists. (Henry *et. al.*, 2004)

Sami Hamoud, a Jordanian economist, was convinced that an interest-free banking system was more just and superior to conventional banking methods and began to carry out his idea. First the leading banks paid no interest in his idea, but with the help of Islamist groups like the Muslim Brotherhood, Hamoud managed to create a public need for a bank with Islamic values.

In 1978 the Jordan Islamic Bank (JIB) was established and 20 years later the Arab Islamic Bank (AIB). The latter, however, was established by a conventional bank and is by some considered to be less Islamic than the JIB. (Henry *et. al.*, 2004)

It is obvious, that the Islamists played an important role in the establishment of the JIB. The Islamists have not only given financial support to the banks, but also given them Islamic legitimacy through assistance, advice and statements in mass media. Still, both banks strongly deny any connection with Islamists. Henry argues that the banks have deliberately avoided too known Islamists in key positions within the banks, but at the same time carefully kept strong ties to Islamic groups as the Muslim Brotherhood. It is clear, that key positions have been offered to persons not too closely linked to Islamists groups and therefore accepted by both the government and the general masses. The Islamists, however, are not truly satisfied with the Islamic banks. Some are frustrated about mismanagement and administrative shortcomings. Especially the JIB is criticized for its lack of innovation and is considered unprofessional. Yet, as Henry mentions, the critic might be unfair and descend from unrealistic expectations of Islamists. (Henry *et. al.*, 2004)

## 6.7. Kuwait

**Country facts**

| | |
|---|---|
| Population: | 2.26 millions |
| Religion: | Muslim 85%, Christian, Hindu, Parsi and other 15% |
| Government Type: | Nominal Constitutional Monarchy |
| GDP- ppp: | $41 billions |
| GDP- Real Growth Rate: | 4.6% |
| GDP- per capita, ppp: | $19,000 |

Kuwait shows great synergy between Islamist politics and economic activity. The Kuwait Finance House (KFH), established in 1977, has been one of the most successful and influential institutions in the Islamic finance industry. The KFH, the country's only Islamic bank, has received enormous support from the government, which had a 49 per cent share at the establishment. The KFH has received special privileges not given to other banks, for instance freedom from Central bank regulation and as Kuwait's only Islamic bank, its monopoly was protected. (Henry *et. al.,* 2004)

KFH has no-risk current accounts but most clients deposit money in savings account based on the Mudaraba principle. The bank has deposits of 1.8 billion KD (Kuwaiti Dinar) (about $6 billion) accounting for 15 per cent of the Kuwaiti market. It is one of the highest market shares that any Islamic commercial bank has in a national market. KFH has had some problems to invest these funds profitably, in accordance with Islamic principles and within the limited economy of Kuwait. Islamic banks attempt to keep finance connected to real goods. The KFH keeps large inventories of automobiles, real estate and other products demanded by the Kuwaitis. The KFH has focused on consumer finance by using the Murabaha. Both economic and political forces have been working to create a new Islamic banking law that would allow new competitors to enter into the market. The Kuwaiti Central Bank has been the strongest force behind this since it has no possibility to regulate the KFH. The KFH has made Islamic finance acceptable in Kuwait and therefore the initiative to pass a new Islamic banking law can be seen as a tribute to the KFH. (Henry *et. al.*, 2004)

The issue of interest has been expressed in the civil and commercial laws of some Muslim countries. In the Kuwaiti Civil Code it is clearly stated that loans shall be without interest and that any condition to the contrary shall be considered interest. In the Kuwaiti Commercial Code it is stated that interest is allowed in commercial loans and that the creditor has a right to receive it. (Saeed, 1996)

There has usually been two ways to solve the issue of dual banking regulation in the Islamic world. A division that deals with Islamic banking can be established or the supervision of the respective banks can be coordinated. In Kuwait, the Finance Ministry, and not the Central Bank, controls the Islamic institutions. In reality, both types of banks, conventional and Islamic, do have to follow the same general rules. The supervision is coordinated between the Central bank and the Finance Ministry. There is a silent agreement that Islamic institutions will receive the same kind of support as the conventional banks should they run into problems. (Warde, 2000)

## 6.8. Lebanon

**Country facts**

| | |
|---|---|
| Population: | 3.7 millions |
| Religion: | Muslim 59.7 %, Christian 39% |
| Government Type: | Republic |
| GDP- ppp: | $17 billions |
| GDP- Real Growth Rate: | 3% |
| GDP- per capita, ppp: | $4,800 |

The Arab Finance House Holding (AFH) was established in Lebanon in 2003. It operates two Islamic banks: Arab Finance House, a commercial bank, and Arab Finance Investment House, the only Islamic investment bank in Lebanon. The AFH manages a capital of USD 60 million and is quickly emerging as one of the region's leading Islamic financial institutions. The corporate sector is offered Islamic investment services such as Murabaha, Mudaraba and Musharaka. Customers are offered several banking and investment services following the Shari'a.

The following accounts are offered: Current Account, Savings Accounts, Deposit Accounts and Investment accounts. Deposit accounts are the ones most used. Several Islamic financial services are offered to clients. Financing can be made in the form of equity such as Musharaka and Mudaraba and in the form of financing instruments such as Murabaha, Ijara, Ijara wa-Iqtina and Bai Istisna. Financing is offered to individuals and in sectors such as service, industrial, agriculture, real estate and commerce. A broad range of investment services are offered. These are compliant with the Shari'a and are all commercially acceptable. The investment services include Musawama, Murabaha, Istisna, Mudaraba and Musharaka. Murabaha is the technique mostly used. Mudaraba is mostly used by companies. The profit sharing rate of Musharaka and Mudaraba is within a limited range. The rate is set by the bank. All these techniques used by the bank are conducted as described earlier in chapter five, except from the Musawama.

Musawama is a sale contract between the bank and its clients to purchase a certain commodity. The bank's purchasing price is pre-agreed and the asset is resold to a client at cost plus a profit. Repayments are done over an agreed period.

In the Musawama contract the client is unaware of the actual cost negotiated with the supplier.

The bank has a Shari'a Supervisory Board. Daily controls of the bank's activities are conducted. All banks operating in Lebanon must follow the law of the Central bank and follow the Lebanese law but there is also a special banking legislation for Islamic banks. A minimum of $100 million is required to receive an Islamic banking license and recently Credit Libanaise, a conventional bank operating in Lebanon paid $200 million to receive the license. The Arab Finance House has plans to increase its scope in the future (Khatib, 2004, interview).

### 6.9. Malaysia

**Country facts**

| | |
|---|---|
| Population: | 23.5 millions |
| Religion: | Muslim, Buddhist, Daoism, Hindu, Christian, Sikh, Shamanism |
| Government Type: | Constitutional Monarchy |
| GDP- ppp: | $207 billions |
| GDP- Real Growth Rate: | 5.2% |
| GDP- per capita, ppp | $9,000 |

Religion plays a two part role in Malaysia. The system of government is secular yet Islam is ever-present although the constitution guarantees freedom of worship for other religious groups. In Malaysia there is a dual banking system with Islamic banks working alongside conventional ones. Islamic Finance has been strongly encouraged and the aim has been to turn Kuala Lumpur both into an international Islamic finance centre and an important conventional regional finance centre able to compete with Singapore and Hong Kong. (Warde, 2000)

The development of the Islamic finance industry has been strongly encouraged by the Central Bank which has also developed instruments and assets to facilitate the industry's expansion. The Islamic Banking Act was passed in 1982 and Bank Islam Malaysia Berhad was the first bank to be established under it. By 2000 it had become the fourth largest Islamic financial banking institution worldwide. In 1993 the Central Bank allowed conventional banks to offer Islamic products to increase competition. (Archer *et. al.*, 2002; Warde, 2000; Al-Omar *et. al.*, 1996)

Islamic banking has been used as a promoter of financial modernization and growth. Malaysian Islamic banking is unique since it offers a wide range of products. The banks are encouraged to do more than just imitate existing models. They should also invent new techniques corresponding to the most modern finance methods used worldwide. Only products that go explicitly against Islamic beliefs are to be excluded. (Warde, 2000)

### 6.10. Pakistan

**Country facts**

| | |
|---|---|
| Population: | 159 millions |
| Religion: | Muslim 97%, Christian, Hindu, other 3% |
| Government Type: | Federal Republic |
| GDP- ppp: | $318 billions |
| GDP- Real Growth Rate: | 5.5% |
| GDP- per capita, ppp: | $2,100 |

In the 1950s, economists in Pakistan had pioneered the study of Islamic banking. In 1979 Pakistan embarked on a programme of full Islamisation of its economy and financial system. The government went further than most Islamic governments in recreating the concepts, language and institutions of early Islam. However, about 20 years later, a leading Pakistani economist stated that the roots of the British banking system were still very strong and the Islamisation was long in coming. The commercial habits and the financial culture created by the British legacy were hard to reform. Also the heavy foreign debt made the International Monetary Fond (IMF) and other foreign creditors have a say in how the economy was managed.

Pakistan is a young nation, even though the idea for a Muslim state has existed for a time. In 1930 the call for a Muslim homeland started. In 1947 the British departed and Pakistan was separated from India. There was a rejection of the multi-confessional and secular India and a will to recreate an Islamic order after a long period of Western colonial rule. The name Pakistan means ‘land of the pure’. According to Warde, the founding fathers were secular, Westernized people who were nonetheless intent on creating an Islamic state. (Warde, 2000)

The government got caught between two sets of conflicting forces. On the one hand, religious groups had been calling for Islamisation. On the other hand, Pakistan carries a long tradition of conventional, interest-based banking and was pressured by the IMF and other foreign creditors to privatize its banking sector and liberalize its economy.

In Pakistan, the government imposed the Islamisation of the economy in 1985. This process was carried out without serious attention to Islamic legal doctrine, leaving the interest-based banking system fundamentally unchanged, but covering it with an Islamic varnish. Thus much of the scholarly literature relating to the Pakistani system either discusses theories, which are totally irrelevant to actual Islamic banking practice, or lists the various ruses used to hide interest-based banking in Islamic terminology. (Ray, 1995)

The political environment in Pakistan during the period when the Islamic banking system was applied can, Al-Omar clamis, be described as extremely unstable both for the economy and for Islamic banking. The economic performance in Pakistan has lacked reliable leadership. During the previous 20 years the economy has behaved like a roller-coaster. The economy did not have the ingredients of sustainable economic growth due to the many inherited structural problems. The performance of the private sector during the same period has, on the other hand, been quite impressive in its growth. The financial system of Pakistan is, according to Al-Omar, made up by well-structured financial institutions such as commercial, co-operative and specialized banks. At the end of June 1994, there were 21 domestic and 20 foreign banks operating in the country. The banking system is, however, characterized by over-regulation by the state bank and other regulatory entities, the predominance of the public sector and inefficient credit allocation as a result of administrative directives. (Al-Omar *et. al.*, 1996)

### 6.11. Saudi Arabia

**Country facts**

| | |
|---|---|
| Population: | 25.8 millions |
| Religion: | Muslim 100% |
| Government Type: Monarchy | |
| GDP- ppp: | $287 billions |
| GDP- Real Growth Rate: | 5.3% |
| GDP- per capita, ppp: | $11,800 |

In Saudi Arabia Islam is the ideological base and the Shari'a is the law of the country. Society and institutions are based on a strict interpretation of Islam. The Shari'a is interpreted according to the Hanbali School of Islamic law and it is enforce by the Saudi kings. The Hanbali School is considered the strictest one on the social behaviour of the faithful but at the same time one of the most liberal Islamic schools of law on business and economic affairs. (Nomani *et. al.*, 1994; Warde, 2000)

The Saudi economy is a mixed market economy. The government chooses which industries are to be established, the speed of the industrialisation and its own role in it. The government's revenues mainly come from the oil industry. No tax is paid in wages or salaries of Saudi citizens. Saudi firms and nationals pay a 2.5 percent zakat on the total annual income and capital gains Sectors of the economy, notably agriculture are subsidised by the government. Tariff protections are provided, some activities are exempted from import duties and local enterprises are encouraged. Basic food stuffs, gasoline, utility and water are subsidised. (Nomani *et. al.*, 1994)

In Saudi Arabia interest payments have always been prohibited. To bypass this the banks charge and pay commission. The Saudi Arabian commercial banking system, except for Al-Rajhis, is in fact based on interest. The Western-style banking system has always been favoured by the government. Officially, all banks operating in Saudi Arabia are by definition Islamic. The issue of Islamic banking is a politically sensitive one and is not recognised in Saudi Arabia. The use of the word Islamic in the name of the bank is even discouraged since it would make the other Islamic banks (without an Islamic name) seem less credible. (Nomani *et. al.*, 1994; Saeed, 1996; Warde, 2000)

Saudi Arabia has a single Islamic bank, Al-Rajhi Banking and Investment Corporation (ARABIC). It was allowed to engage in non-interest banking as long a sit did not use the word Islamic in its name. The bank pays no interest on its accounts and it only pays out a very small proportion of its profits to the depositors. (Henry *et. al.*, 2004; Archer *et. al.*, 2002; Warde, 2000)

Islamic financial institutions have been operating in the country since the late 1970s. This development has not been liked by the government. As a result, the SAMA, the Central Bank of Saudi Arabia, has refused to license the banks instead of prohibiting them. Both the Al-Baraka and the Faisal Group are principally owned by Saudis but they have not yet obtained commercial banking licences in Saudi Arabia. (Nomani *et. al.*, 1994; Warde, 2000; Henry *et. al.*, 2004)

### 6.12. Sudan

**Country facts**

| | |
|---|---|
| Population: | 39 millions |
| Religion: | Sunni Muslim 70%, indigenous belief 25%, Christian 5% |
| Government Type: | Authoritarian Regime |
| GDP- ppp: | $70 billions |
| GDP- Real Growth Rate: | 5.9 % |
| GDP- per capita, ppp: | $1,900 |

Some of the financial methods used in the Sudan earlier were very much like the ones used by Islamic financial institutions today. The financial sector was controlled by legislation based on British laws and practice. Sudan became independent in 1956 and ever since members of the political establishment had called for the implementation of an Islamic constitution. In 1971 the commercial banks, largely foreign-owned, were nationalized. The government began to encourage financial institutions to establish branch offices in Khartoum, the Sudanese capital. Islamic finance did not emerge before the 1970s. No Muslim government has tried to abolish interest before the 1970s but Islamic governments in Sudan, Iran and Pakistan have worked to eliminate interest from their financial banking systems. (Henry *et. al.*, 2004; Saeed, 1996)

The first real Islamic financial institution that set up offices and did business in the Sudan was the Faisal Islamic Bank of Sudan (FIBS).

The bank was established in 1977, by a special unprecedented Act of Parliament. This Act gave the bank very valuable benefits. To mention a few, the bank received tax exemptions on employees´ salaries and pensions, as well as on all assets and profits. The bank was also given full freedom to use and transfer its foreign currency deposits. The FIBS was successful and this led to more Islamic banks being established. Some of these new banks used Islamic in the name for PR purposes. (Henry *et. al.*, 2004; Warde, 2000)

Many Islamic banks are represented in Sudan, both domestic and foreign. The share of checking accounts and savings accounts is much larger compared to the share of investment account than what is the ordinary in Islamic banks around the world. Islamic banks in the Sudan only use a few contracts. The most common contract has been murabaha but also musharaka and ijara are used. Mudaraba is of very little importance. Significant changes have taken place in the use of the contracts. Musharaka is continuing to grow in importance. Musharaka and mudaraba have an equal share of the total volume of financial transactions in the formal sector of the economy; both have about 35 per cent share. In the beginning of the 1990s the murabaha accounted for 80 per cent. This shows an important change in the investment profile of the bank. Murabaha are mostly used for short-term deals while musharaka contracts are used for long-term investments. The main force behind this change towards more use of musharaka finance has been government pressure. The government wanted to minimize the use of synthetic murabaha contract and they should not account for more than one-third of the total volume of finance. It also wanted to increase long-term finance. (Samuelson, 2000; Henry *et. al.*, 2004)

The nature of agricultural finance has changed and it resulted in the introduction of salam contracts at the beginning of early 1990s. As Warde suggests this method has great potential in agricultural areas. Salam contacts are used only in the agricultural sector of the economy but it is becoming less common even there. In 2000 salam contracts were used in less than 20 per cent of the volume of the agricultural finance. Murabaha is used in every sector of the economy. Its share in import and export trade is 80 and 100 per cent, respectively. Some banks do not use salam constracts while other almost only use murabaha contracts.

Foreign banks specialized in import/export choose to use only murabaha. Islamic banks tend to invest in short-term commercial transactions and not industry and agriculture. In the agricultural Sudan only four percent of the investment was made in agriculture while 90 percent were in import-export transactions. (Warde, 2000; Henry *et. al.*, 2004)

Henry summarizes Islamic banking in the Sudan as a paradox. There is fundamental lack of confidence in the banking system. There is a very low level of financial intermediation in the economy. The deposits are limited and continue to decline and the credit to the private sector continuously gets smaller. Islamic finance has not been a success from an economic viewpoint. In fact, the financial sectors are extremely weak. On the other hand, Islamic finance has been an enormous success from a political viewpoint. (Henry *et. al.*, 2004)

### 6.13. Turkey

**Country facts**

| | |
|---|---|
| Population: | 68.9 millions |
| Religion: | Muslim 99.8%, other 0.2% (mostly Christian and Jews) |
| Government Type: | Republican Parliamentarian Democracy |
| GDP- ppp: | $458 billions |
| GDP- Real Growth Rate: | 5.8% |
| GDP- per capita, ppp: | $6,700 |

The Turkish state was established in 1923 and has been secular ever since. Political Islam has been suppressed and Islamic business repressed. In January 1980 the World Bank and the International Monetary Fund helped initiate a market-oriented economic model. Islamic groups took advantage of this and became one of the major actors in the economic field. The state ideology was transformed and the development of an Islamic economy was encouraged.
Ever since, Islam has played an important role in Turkish social, political and economic life. Many factors facilitated the establishment of an Islamic economy in Turkey. (Henry *et. al.*, 2004)

Islamic banks were allowed to open in 1983 and the first interest-free bank of Turkey was opened in 1985.

Islamic Banks, established by Turkish shareholders and Gulf investors, opened in Turkey. They were however not allowed to use the word Islam in their names nor refer explicitly to their Islamic character. The banks were granted special privileges and rights that conventional banks did not enjoy. (Warde, 2000; Henry *et. al.*, 2004)

Turkey is the non-Arabic country that has the most dynamic private Islamic banks. There are five private 'special finance houses'. Three of them are partly owned by the Kuwait Finance House, the Faisal Group and the Al-Baraka Group, respectively. The five banks expand their branches network into Istanbul, Ankara and the provinces. Officially they are part of the Turkish commercial banking system. (Henry *et. al.*, 2004)

Two types of accounts are offered at the special finance houses: current accounts and profit-sharing accounts. The current accounts do not give any return and are used to a very small extent compared to the profit-sharing accounts. The profit-sharing accounts can be opened in Euros, US Dollars or Turkish Lira for a minimum of thirty days. Once the investment has ended profits are shared between the finance houses and the depositors. The finance houses receive 20 percent of the profit. Murabaha is the most popular fund but Mudaraba and Ijara are increasing in importance. (Henry *et. al.*, 2004)

### 6.14 Summary

The development and implementation of Islamic banking is a very wide subject. Every country has its own unique history, natural resources, politics and beliefs and this leads to each country having its own prerequisites and possibilities. The possibility for the Islamic banks to invest in profitable projects also varies largely between the countries. Despite this fact, there are some similarities present between the countries.

The situation differs between the countries. Each country has its own history and political system. In the 1940s and 1950s Pakistan and Sudan became independent of Great Britain.

In 1979 the revolution in Iran began which led to several important changes in society. Saudi Arabia, on the other hand, has enjoyed its independency for a long time without major foreign influences. The political situation varies greatly from nation to nation. In Iran the clergy and other religious leaders have complete power and run most authorities. The country is very homogenous through its political and religious isolation. The contrary state would be Malaysia, where religion and politics are separated. Although Islam is ever-present in society the system of government is secular.

The financial conditions differ largely between the countries having Islamic banking system. The wide range of countries covers such different countries as the poor country Sudan with only a GDP of $1,900/per capita and the much wealthier Kuwait with its $19,000/per capita. The population and thereby also the workforce can constitute a resource as well as an obstacle, depending on its size and education. The availability of projects to invest in is somewhat connected to the natural resources in the country. What might be more important is the countries' governments' attitude towards the Islamic banks and how they are dealt with. In some countries the development of Islamic banks is strongly encouraged while in others the government takes a more neutral position towards them and let the banks take care of their own business.

As mentioned above there is plenty of variations between the nations. Yet, specific similarities across nation borders emerge while analysing the circumstances in the various states.

In some countries the entire banking system has been nationalised through governmental actions. This nationalisation has been conducted as a step in the process towards complete Islamisation of the entire society, including the whole banking system. These actions have been taken for several reasons. The most prominent is giving the religion a stronger place in society and making the religion the fundament of business life as well as the social, political and juridical life. In Iran, Pakistan and Sudan the authorities have implemented this process of nationalisation of banks and complete Islamisation of society.

This means that the banks, on the one hand, are rather strictly controlled as to their working conditions officially and on the surface. On the other hand, the work inside the banks is usually not controlled by a Shari' a Supervisory Board, since these are normally not present in banks that have been islamised through governmental actions. (See further paragraph 7.2)

Another interesting aspect of the Islamic banks is the ownership of them. The banks can be state owned, private or a mix of the two. In Egypt, for instance, the three largest Islamic banks are often referred to as privately owned banks, while in reality the state owns between 20 and 80 per cent of the banks. In Kuwait the government had a 49 per cent share in the KFH at its establishment. In Indonesia the Islamic bank's mission has been to help the government in the process of national economic development. The shareholders of the banks are mostly non-Muslims and it can be assumed that the bank is privately owned at least to a large extent. In Turkey the Islamic banks have been established by Turkish shareholders and Gulf Investors and are therefore privately owned by both domestic and foreign investors.

In some states the development of Islamic banks has a very strong connection to Islamist political groups. In Jordan the Muslim Brotherhood played a very important role both in the establishment and the continuity of the Islamic banks. The banks have been strongly promoted by the Islamist group, although the banks do not admit to having any connection to the group, since it would damage the image of the bank. In Turkey the World Bank and the International Monetary Fund encouraged the establishment of a market-oriented economy. Islamic groups took advantage of this and became the dominant actors in this field and they led the development of an Islamic economy which led to the establishment of Islamic banks.

In most cases the connection between Islamic groups and Islamic banks is apparent. Still, in some countries the Islamic banks are prohibited from using the word 'Islamic' in the name of the bank as well as referring explicitly to their Islamic character. The argument behind this is the risk for political negative association.

This was the case in Egypt in the beginning of the Islamic banks' history there. The situation is still the same in Turkey where the Islamic banks are usually called 'special finance houses' or similar names. In Saudi Arabia all operating banks are by definition Islamic but are discouraged from using 'Islamic' in the name, since it would make other banks seem less credible.

The establishment and development of Islamic banks in Saudi Arabia is strongly disliked by the government. The Saudi Central Bank has, as a result, refused to license the Islamic banks instead of prohibiting them. The two multinational banking groups, Al-Baraka and Al-Faisal practically owned by Saudis, have not yet obtained commercial banking licences to operate in Saudi Arabia. On the contrary, the role of the Central Bank in Malaysia is quite different. In Malaysia the Central Bank has strongly encouraged the development of the Islamic finance industry.

Another strong authority behind the development of the Islamic banks is in many cases the government. The Kuwait Finance House (KFH), for instance, has received enormous support and special privileges from the government. As Kuwait's only Islamic bank its monopoly has been protected and the bank has been exempted from Central Bank regulation. The Faisal Islamic Bank of Sudan was given valuable benefits through a special Act of Parliament. Also in Turkey the Islamic banks have been granted special privileges and rights that conventional have not enjoyed.

There is a division between the nations in the aspect as to what extent the Islamic banks cooperate with their respective governments. More or less all of the Islamic banks cooperate in one way or the other but there is large uncertainty on this subject. Since Iran, Sudan and Pakistan all have nationalised their banks it is obvious that the governments have a strong influence over the Islamic banks. In Indonesia the government has used the Bank Muamalat Indonesia (BMI) in developing the national economy, especially in relation to small- and medium-scale entrepreneurship. In other countries as Egypt and Kuwait with partly state-owned Islamic banks the governments do not appear to interfere as much in the operations of the Islamic banks.

As mentioned above Saudi Arabia differs from the other nations as regards cooperation with the government. In fact, the Saudi government has not approved of the establishment and development of the Islamic banks in the country.

In several states the Islamic banks compete with conventional banks. In some countries, such as Egypt and Lebanon the government and/or Central bank allow and sometimes – as in Malaysia – even encourage conventional banks to offer Islamic services. This is done to increase competition. In Kuwait both political and economic forces have been working to create a new Islamic banking law allowing new competitors to enter into the market.

The products offered by the Islamic banks are rather similar across borders. Current/deposit accounts and savings accounts are to be found in Iran, Kuwait, Lebanon, Malaysia, Sudan as well as in Turkey. Also investment accounts are offered in those countries. In Kuwait, Lebanon and Sudan the current and savings accounts are the ones mostly used. In Sudan the investment accounts are used to a much lower degree than what is the ordinary in the Islamic banks around the world. In Turkey, on the other hand, the investment accounts are being used to a very large extent. Most nations offer a variety of financing alternatives, although murabaha seems to be the most commonly used in Kuwait, Lebanon, Sudan and Turkey. The Islamic banks in Malaysia offer a wide range of products. Innovation is strongly encouraged and the banks should do more than just imitate existing models. New techniques corresponding to the most modern finance methods used worldwide should be invented, only excluding products not conforming to the Shari'a.

In Saudi Arabia interest payments have always been prohibited. Instead the banks charge and pay commission but the larger part of the banking system is in fact based on interest. The Pakistani interest-based banking system appears to continue rather unchanged even after the Islamisation of the economy, nevertheless now operating using Islamic terminology. In Kuwait both civil and commercial laws mention interest.

The Kuwaiti Civil Code clearly states that loans shall be without interest while in the Kuwaiti Commercial Code it is stated that interest is allowed in commercial loans and that the creditor has a right to receive it.

As we can see the same products within Islamic banks are present in all the countries selected, but they are used to various extent. The working conditions differ greatly between the nations depending on several reasons, like why the banks were established and what function they have in society. The role of the banks changes continuously as the financial, political and religious environment changes. It can not be emphasised enough that the present Islamic banks are a new phenomenon that has only existed for three decades. The existence and presence of Islamic banks will continue to develop and change over time. The assortment as well their use will probably go through several modifications. The future expansion and development of the Islamic banks and their impact on finance and global economy remains to be seen.

**Chapter Seven**

# 7. ADVISORY AND REGULATORY ORGANS

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*Shari'a Supervisory Board are presented as well as different organizations working to achieve international harmonisation within the Islamic Banking.*

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## 7.1. INTRODUCTION

Some countries have a dual financing system – both conventional and Islamic. Debates are going on whether both systems should have the same rules and regulations. Most Islamic banks favour separate treatment and usually give two main reasons. One is that the religious factors are the most important and the other is that the Islamic operations are fundamentally different from the conventional ones. Islamic banks claim that it is unfair to treat the main Islamic financing techniques as conventional loans since many of them are not lending but merely financing or sales. On the other hand conventional banks claim that the competition is unfair since the Islamic banks receive special privileges. (Warde, 2000)

Many Central Banks do not have the legislation or the tools to supervise Islamic banks. They do accept the concept of Islamic banking and strongly consider specific regulations and laws for the Islamic banks. Within the Islamic world, the issue of dual regulation has been resolved in different ways. There is contradictory information as to which countries have what kind of legislation but according to the latest literature it has been done in the following way. These can be categorized into three main groups. The first group of countries has enacted Islamic Banking in their law. Turkey, Malaysia, Iran, Sudan, Yemen and United Arab Emirates have all done that. The second group has not yet enacted regulating laws for Islamic banks. The countries that fall into this group are Saudi Arabia, Egypt, Jordan, Qatar and Bahrain. In these countries the Islamic Banks have to follow the same laws as the conventional banks. The laws in these countries are mostly focused on commercial banking. Lebanon is part of the third group in which Islamic Banking law has not been enacted. However, Islamic banks are subjected to the country's fiduciary law. In all these three groups the Islamic banks are supervised by the Central Bank.

In other countries, such as Kuwait, Islamic banks are supervised by the Ministry of Commerce. (Abdel Karim, 2001)

The regulatory authorities in many countries are determined to increase the control over Islamic banks. Generally more Central banks are positive towards extending support and supervisory control to Islamic banks than before. One important issue of uncertainty is still to be resolved and that is whether Islamic banking is judged by the Shari'a courts or the civil laws court. The legal system needs to be well-defined and integrate both Shari'a law and the existing banking system. One example could be to harmonise the property-rights system and contracts recognised by civil law and Islamic-based contracts and modes of financing. (Al-Omar *et. al.*, 1996)

### 7.2. SHARI'A SUPERVISORY BOARD

The Shari'a Supervisory Boards also go under the name Religious Supervisory Board/ Committee. To ensure the Islamicity of Islamic banking at private sector level, particularly in the Middle East, Religious Supervisory Board is used. Scholars of Islamic law are employed for their consulting and advisory capacity. They examine the bank's contracts, dealings and transaction in its day-to-day activities. The aim is to ensure that the bank follows the Shari´a. There are differences in the composition of these boards. Some consist of only one person and others of a group of persons. They are given wide power and authority and can examine activity, method or contract to check the conduct of the bank. The Boards are free to use any means available in order to fulfil their task. According to Samuelson there are important differences in the authorities of the Boards. Some Boards work as advisors to the management while at other banks the Boards have the final say and the management has to follow the Board's decision. Ray states that in case of disputes between the bank and its clients the decisions of the Board are final. (Saeed, 1996; Samuelsson, 2000; Ray, 1995)

The role of Shair´a Supervision is fundamental to Islamic banking and it is necessary for the legitimacy of the institution. There can be said to be two categories of Islamic banks or Islamic Financial Institutions.

The first one includes institutions that were established initially to operate within Islamic Shari´a and restrict their operations to its bounds. Most of them have a board according to Shaikh's survey from 1997. The other category consists of institutions which have been ordered by their national legislatures to shift from conventional to Islamic Banking. Most of them do not have a Board. This has taken place in three Islamic countries, namely, Pakistan, Iran and Sudan. (Shaikh, 1997)

To make sure that the activities in the banks follow the Shari'a the Boards usually work in the following way. There are certain banking and financial problems that need to be looked at by the Board. When this occurs, the management analyses the problem and then suggests a solution that could be suitable from a banking and financial view-point. The opinion of the Board is then sought. If the Board finds no objections to the solutions from a Shari´a viewpoint, the Board will approve of it. If any objections to the solution or parts of it have been found, the Board will express its opinion on the matter and recommend further modification. (Saeed, 1996)

The boards usually justify their views on the basis of the Koran or Sunnah (if available) or on views of early jurists. They also search in the Islamic jurisprudence (*fiqh*) for parallels to modern banking and financial transactions, even though the transactions have been developed in modern times. According to Saeed, who is somewhat critical to the work done by the Boards, the Boards do not seem to take into consideration the historical relevance of certain transactions which were prohibited. Besides that, they do not give sufficient consideration to the level of authenticity of some *Hadith* which they quote to justify a given transaction. Saeed further argues that such an approach to modern banking and financial transactions does not seem justified since the Shari´a did not restrict the development of commercial institutions explicitly or implicitly. Rather, Shari´a left it to the Muslims to develop such institutions as the circumstances dictated, as long as there was no violation of an explicit Shari´a rule. (Saeed, 1996)

It is important to remember that although all banking activities must conform to Shari'a the banks must also follow the national law of the country in which the Islamic bank operates. (Samuelsson, 2000)

## 7.3. THE ISLAMIC FINANCIAL SERVICES BOARD (IFSB)

The Islamic Financial Services Board (IFSB) serves as an international standard setting body of the regulatory and supervisory agencies that have interest in ensuring the soundness and stability of the Islamic financial services industry. The establishment of the IFSB was the result of a two-year consultative process initiated by a group of governors and senior officials of central banks and monetary authorities of various countries, together with the support from the Islamic Development Bank (IDB), the International Monetary Fund (IMF), and the Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI). The IFSB has been in operation since March 2003 and its host country is Malaysia, which has enacted a law that gives the IFSB the immunities and privileges that are usually granted to international organizations and diplomatic missions. (www.islamic-banking.com)

The IFSB has a role similar to that of the Basel Committee on Banking Supervision in conventional banking. The primary objective of the IFSB is to develop uniform regulatory and transparency standards that are targeted to address characteristics specific to IFIs. According to Archer, the wish is that the IFSB will support the implementation of the regulatory standards for IFIs defined by the AAOIFI, since the IFSB is strongly supported by the Central banks.

The size of the membership of the IFSB has increased from the nine founding members to reach 60 members currently. The membership of the IFSB is divided into three categories, namely Full Member, Associate Member and Observer Member. The Full Membership, which is the sole membership with voting rights, is available to the leading financial supervisory authority of each sovereign country. The recognition IFSB received from regulatory and supervisory bodies as well as financial institutions worldwide reflects the continuing growth of this industry as well as the optimism on the prospects of the Islamic financial system, claims Abdel Karim, Secretary-General of the IFSB.

Today – in 2004 – the IFSB members include five international inter-governmental agencies (International Monetary Fund, World Bank, Islamic Development Bank, Bank for International Settlements and Asian Development Bank) as well as 37 financial institutions. (www.ifsb.org)

The IFSB has begun the development of two prudential standards for the Islamic financial services industry namely, Capital Adequacy and Risk Management standards. These two standards are expected to be issued by early 2005. This year, the IFSB plans to start preparing a standard on Corporate Governance. (www.ifsb.org)

## 7.4. THE ACCOUNTING AND AUDITING ORGANIZATION FOR ISLAMIC FINANCIAL INSTITUTIONS (AAOIFI)

During the past two decades there has been an increasing interest in enhancing the harmonisation of accounting and financial reporting by banks. The Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI) is an organization based in Bahrain and it was established in 1991 by major Islamic banks and other interested parties. Its purpose is to prepare and issue auditing, good governance, ethical and Shari'a standards, as well as Shari'a rules for investment and financing instruments for Islamic financial institutions. The AAOIFI is a self-regulating agency that works closely with IFIs and Central banks to identify and propose standards, which, however, the AAOIFI has no authority to enforce. Islamic banks took the initiative to self-regulate their financial reporting because, Abdel Karim claims, they feared that the regulatory bodies in the countries in which they operate would otherwise "intervene and mandate the accounting policies of Islamic banks". (Abdel Karim, 2001, p 173)

The structure and processes of Islamic banks do not fit with those of conventional universal banking, which combines both commercial and investment businesses. This seems to have resulted in supervisory bodies adopting different approaches to regulate Islamic banking. Such variations in the regulation of Islamic banking appear in turn to have resulted in Islamic banks adopting different accounting treatments for the same transaction.

Despite that, most of the countries in which these banks operate either by using the International Accounting Standards (IAS) as their national standards or developing national standards based primarily on IASs. (Abdel Karim, 2001)

According to Archer, there are clear differences between the balance sheet structure of an Islamic financial institution and that of a conventional bank. The conventional banks deal with spread-based fixed income instruments, whereas in the balance sheet of an Islamic bank the major component of the liabilities and equity side is investment accounts on a profit-sharing basis. Such differences have important implications for accounting and financial reporting. The purpose of the AAOIFI is, Archer states, to find a way to eliminate those differences in order to simplify comparisons between the different bank systems. (Archer *et. al.*, 2002)

The AAOIFI considers its developed accounting standards to be complementary to the IAS issued by the International Accounting Standards Committee (IASC), since those do not cover the Islamic banking transactions completely. (Archer, 2002) The AAOIFI's standard, however, are specifically developed to cater for the unique characteristics of the Shari'a contracts that govern the Islamic banks' financial instruments. (Abdel Karim, 2001)

In 2002 the AAOIFI had issued 18 accounting standards, four auditing standards, four governance standards, five Shari'a standards and four Shari'a rules, in addition to a code of ethics. According to Archer, increasing convergence in Islamic financial practice will undoubtedly increase client confidence in the industry and support interbank transactions between Shari'a-compliant institutions. (Archer *et. al.*, 2002)

The AAOIFI has made major efforts to inform banking supervisors and encourage them to use the AAOIFI standards as the benchmark for IFIs in their jurisdiction in order to improve the transparency and comparability of the financial reporting. The efforts of the AAOIFI have become successful in some countries, where banking supervisors today require Islamic banks either to comply with AAOIFI's standard or are specifying AAOIFI's standards as guidelines.

Malaysia, Bahrain and Sudan are the leaders in the development of specific regulatory guidelines for the Islamic banking industry. The Bahrain Monetary Agency and the Central Bank of Sudan require all Islamic banks under their jurisdiction to meet these standards, and Islamic banks elsewhere to comply voluntarily with the AAOIFI standards. In 2000, the Saudi Arabian Monetary Agency told Islamic banks and Islamic subsidiaries of conventional banks operating in the Kingdom to use AAOIFI standards. There are, however, still a number of countries in the Middle East that do not use the AAOIFI's standards. Also in Europe and Western countries, according to Archer, supervisors have not yet given these standards serious consideration. (Archer *et. al.*, 2002)

**Chapter Eight**

# 8. ISLAMIC DEVELOPMENT BANK (IDB)

*The Islamic Development Bank is briefly presented in this chapter.*

The Islamic Development Bank is an international financial institution and it was formally opened on 20 October 1975. The official language is Arabic, but also English and French are used. The Bank has its main office in Saudi Arabia and has three regional offices. Field representatives of the Bank are also present in eleven member countries. Currently the Bank has 55 member countries. All member countries must also be a member of the Organization of the Islamic Conference. The member country must pay its contribution to the capital of the Bank and accept terms and conditions decided upon by the IDB Board of Governors.

The Bank's purpose is to support the economic development and social progress of member countries and Muslim communities. The Bank participates in equity capital and grants loans for productive projects and enterprises. Furthermore it assists member countries financially in other forms for economic and social development with all activities complying with the Shari'a. The Bank can receive deposits and mobilize financial resources through methods acceptable according to Shari'a. The Bank must also promote foreign trade, especially in capital goods, among member countries. Furthermore it should provide technical assistance to member countries and assist in training personnel working with development activities in Muslim countries.

The authorized capital of the Bank is 15 billion Islamic Dinar (ID) and the subscribed capital is ID 8.1 billion. Islamic Dinar is the accounting unit in the Bank. Its value is equivalent to one Special Drawing Right (SDR) of the International Monetary Fund. (www.isdb.org)

**Chapter Nine**

# 9. ISLAMIC BANKING IN NON-MUSLIM COUNTRIES

*The presence of Islamic Banking in non-Muslim countries is shortly presented.*

Most of the Islamic banks are situated in Muslim countries. Islamic banking services are, however, offered in other countries as well. An increasing number of conventional banks have opened Islamic windows. These Islamic windows are not independent financial institutions. They are departments within the conventional banks and offer product that comply with Shari'a. Citibank has established an Islamic banking subsidiary. One example of a conventional bank with Islamic windows is Hong Kong and Shanghai Corporation (HSBC). Other examples are American Express Bank, American Bank, Chase Manhattan, Union Bank of Switzerland and BNP-Paribas. Other countries where Islamic services are offered through conventional bank's Islamic windows are China the United Kingdom, Germany and Luxembourg. (Archer *et. al.*, 2002)

Chapter Ten

# 10. THE FUTURE OF ISLAMIC BANKING

*The future of Islamic Banking is discussed as well as specific problems the Islamic banks might encounter.*

A pure profit-and-loss-sharing system has some specific qualities but demands a lot of the Islamic banks. The bank cannot know in advance its absolute income from its activities. In order to receive information the Islamic bank has to study and evaluate entrepreneurial proposals and their economic viability. This is a task that requires highly qualified personnel. Business operations financed by them must be supervised and audited with great care. In this respect, Islamic banks need to have or engage more staff expertise than conventional banks. The bank must also protect itself from manipulation of the profits, which are to be shared. At the same time the bank must offer its depositors attractive PLS projects. The financing of these must break even and quickly provide an income for the bank. (Al-Omar *et. al.*, 1996)

Islamic banks will always have disadvantages compared to conventional banks concerning its financial instruments. If Islamic banks develop new instruments, conventional banks can easily adopt them if these are judged profitable. Islamic banks cannot to the same extent adopt all the instruments available to conventional banks, since the Shari´a must be followed. (Al-Omar *et. al.*, 1996)

The banks have to provide their depositors with a higher rate of return than the rate paid in interest in comparable financial institutions since the Islamic bank's depositors assume a greater degree of risk. The Islamic banks can face real problems here. They have to look for investment opportunities in all sectors of the economy, not only in the ones that promise to yield a quick and high return but also investment projects that give a long-term social return. Projects in infra-structure are socially beneficial but these yield a low or negative rate of return. (Zineldin, 1990)

When the idea of Islamic banks appeared in the 1970s, the conventional banks declared it impossible. The development of Islamic banks, though, has proven successful – especially within Muslim countries. Today, even conventional banks have enlarged their banking services to include so-called 'Islamic windows'. The reason behind the high demand of Islamic banks is of course the strong position of the religion Islam. Samuelsson mentions three possible explanations to the successful establishment and expansion of Islamic banks. It could be seen as a sign of an increasing awareness of Islam as an ideology, as a sign of fundamental streams within Islam, or as a sign of economic growth in the Gulf-region. (Samuelsson, 2000)

The growth in number and financial strength among the middle class is, according to Samuelsson, of economic importance for the continuous expansion of the Islamic bank system. The most important is to use the income of the oil production to find new income sources. There have been discussions whether or not Islamic banks could operate successfully in non-Muslim countries. One opinion is that Islamic banks will have no success in countries that do not have laws like the Shari'a that forbid interest. Another opinion declares that the high sense of ethic and finance that is connected to Islamic banks could very well apply to non-Muslims as well. The reasons behind would simply be of financial and moral nature. (Samuelsson, 2000)

During the 1990s a trend of economic behaviour based on ethical rules has grown stronger, even in the Western world. In both Europe and the United States this ethical trend has become noticeable. However, the obvious connection between the Islamic banking system and Islam is the biggest problem, since it arouses suspicion among European and American people. A way to avoid this 'guilt-by-association' is maybe to present the bank as an interest-free bank instead of Islamic. (Samuelsson, 2000)

According to Archer, the future of the Islamic financial sector depends on its capacity to innovate – to improve the competition concerning the range of products and services and the ability to manage the risks more efficiently.

In order to compete with the traditional conventional bank it is important for the Shari'a scholars to produce Shari'a-compliant financial instruments that meet the market needs of today. One of the most important needs is to harmonise the rich variations of the Shari'a rulings through an acceptance of Shari'a standard issued currently by AAOIFI. By doing so, the scholars would be focusing on the implementation of the standard, instead of producing individual and diverse solutions to Shari'a issues. (Archer *et. al.*, 2002)

There is also a need for firms active in financial markets to have a high quality of corporate governance, which in turn depends on ethical standards being observed. In this context, the role of financial industry regulators needs to be considered. For IFIs, a new international regulatory body – the Islamic Financial Services Board (IFSB) – has been established by the Central banks of a number of countries in which IFIs operate. The IFSB will issue voluntary supervisory and prudential standards for its members, on a similar basis to those by the Basel Committee of the Bank of International Settlements for its member countries (the so-called G 10). In addition, the IFSB will issue voluntary standards for the regulation of Islamic financial services. (Archer *et. al.*, 2002)

Through the AAOIFI and the IFSB international standards of excellence in key aspects as corporate governance, risk management and financial reporting can be reached. The importance of Islamic finance becomes visual through the number of major multinational banks that offer Islamic financing facilities services. Banks like Deutsche Bank, Citibank and Arab Banking Corporation all offer Islamic-financing products and this makes Islamic finance better known to the global financial community. This competition has given the dedicated Islamic banks fewer resources and more limited global reach, which have led to a series of mergers and that will probably continue in the future. (Archer *et. al.*, 2002)

The loyal customer base of Islamic banks together with its "track record of providing profitable financial products", the Islamic banks should be rather well positioned to survive the present downturn in global markets, and take advantage of the upturn when it arrives.

In increasingly global financial markets, Islamic banking can increase its credibility by introducing common reporting standard like the standards developed by the Accounting and Auditing Organisation for Islamic Financial Institutions (AAOIFI). (Archer *et. al.*, 2002, p 41)

Chapter Eleven

# 11. REFLECTIONS

*This chapter contains personal reflections that have arisen during the writing of this dissertation. Encountered difficulties while working with the material are mentioned and suggestions for further research are given.*

The journey that has been experienced while writing this dissertation has been very enriching and interesting. Each part of the dissertation has opened up the door to several new subjects as well as new perspectives and aspects. The subject of Islamic banking is to various degrees connected to other subjects such as religion, history and politics. It would be impossible to give a clear picture of Islamic banking without also discussing these subjects to some extent. Much literature has been written on the subject throughout several decades, much of which is not in English. Since we base this dissertation on literature written in English there is a risk that we have overlooked other important sources of knowledge and information for instance in Arabic.

A few parts of the literature caused some confusion and mental exertion. The authors, whose works we have used, tend to use several different English names for the same concept in Arabic and even new Arabic terms have occurred as the dissertation has been written. There is a need for harmonisation in the use of language. Otherwise the material has been very interesting, informative and some even excellently written.

This dissertation is not an attempt to give a complete presentation of the Islamic Banking system but rather to present its fundamental parts, important issues related to it and to give an overview of the present situation in some selected countries. Some aspects have merely been mentioned shortly while others have been discussed more thoroughly. The ownership of the Islamic banks is one area that only has been mentioned shortly and could be a subject for further research.

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